

GAO

Report to the Chairman, Committee on
Ways and Means, House of
Representatives

July 2006

TAX-EXEMPT ORGANIZATIONS

Collecting More Data
on Donor-Advised
Funds and Supporting
Organizations Could
Help Address
Compliance
Challenges





Highlights of GAO-06-799, a report to the Chairman, Committee on Ways and Means, House of Representatives

TAX-EXEMPT ORGANIZATIONS

Collecting More Data on Donor-Advised Funds and Supporting Organizations Could Help Address Compliance Challenges

Why GAO Did This Study

Donor-advised funds and supporting organizations are two charitable-giving options that have received attention from Congress and the Internal Revenue Service (IRS) for their potential to facilitate noncompliance with tax law. As requested, GAO is providing information on donor-advised funds and supporting organizations related to (1) federal laws and regulations, compared to private foundations; (2) financial and organizational characteristics; and (3) types of noncompliance and promotion methods and challenges identifying them.

What GAO Recommends

GAO suggests that Congress consider (1) directing IRS to collect Form 990 data for, and provide guidance on calculating payout rates for donor-advised funds and supporting organizations, and (2) providing IRS authority to protect from public disclosure the taxpayer identification numbers (TIN) of loan recipients, so that IRS can collect the TINs on the Form 990. GAO recommends that IRS require (1) more comprehensive reporting of donor-advised fund data, (2) reporting of supported organizations' identification numbers, and (3) reporting of TINs for recipients of large loans, if granted authority to protect the TINs from public disclosure.

IRS agrees with the first two recommendations but believes it needs legislative authority to protect loan recipient TINs.

www.gao.gov/cgi-bin/getrpt?GAO-06-799.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

What GAO Found

Donor-advised funds, supporting organizations, and private foundations are all tax-exempt charitable-giving vehicles. Donor-advised funds are separate accounts held by a public charity to receive contributions from donors who may recommend, but not control, charitable distributions from the account. Supporting organizations are public charities that are to carry out their tax-exempt purpose by supporting one or more tax-exempt organizations, usually other public charities. Compared with private foundations, donor-advised funds and supporting organizations give donors less control over how their donation will be used but provide donors more favorable tax deductions, lower administration costs, less IRS oversight, and fewer reporting requirements.

Donor-advised funds hold billions of dollars in assets, and supporting organizations and private foundations hold hundreds of billions of dollars in assets. Public charities and private foundations must annually file an IRS Form 990 or Form 990-PF, respectively, to report their activities. However, donor-advised fund data are limited because organizations that maintain the funds are not required to separately report fund data from other financial data on Form 990. Although some supporting organization characteristics can be determined from Form 990 data, other characteristics, such as the rate at which payments are made to charities and details about the recipients of loans from the organization, cannot be reliably determined. Concerns have arisen about the "payout" rate to charities, and Congress is considering a minimum payout requirement, similar to the one for private foundations. Further, supporting organizations are not required to report their supported organizations' identification numbers, making it more difficult to track the relationship between organizations. To collect additional data, IRS revised Form 990 for 2003 and 2005 and is considering further revisions, but no firm plans have been determined.

According to IRS managers, examinations reveal that some donor-advised funds and supporting organizations are used in abusive schemes to unallowably benefit donors or related parties or give donors excess control of charitable assets and operations. In some cases, IRS is able to clearly determine noncompliance and assign appropriate corrective actions. However, in other cases, IRS faces challenges gathering evidence or addressing activities that do not seem to benefit charities, but do not violate any law or regulation, such as when a supporting organization loans money, at market rate, to a donor, director, or officer of the organization. Promoters, who are individuals or entities who facilitate abusive schemes, further complicate IRS's examination efforts.



United States Government Accountability Office
Washington, DC 20548

July 27, 2006

The Honorable William M. Thomas
Chairman
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Each year, millions of donors give hundreds of billions of dollars to charities.¹ The Internal Revenue Service (IRS) estimated that for tax year 2002, charitable contributions totaled over \$229 billion, the largest portion coming from individuals and foundations.² In addition to traditional public charities and private foundations, donors may make charitable contributions through the use of donor-advised funds and supporting organizations. Donor-advised funds are generally separate funds or accounts established and maintained by a public charity to receive contributions from a single donor or a group of donors.³ While the donor may recommend charitable distributions from the account, the charity must be free to accept or reject the donor's recommendations. Supporting organizations are public charities that are to carry out their tax-exempt purpose by supporting one or more tax-exempt organizations, usually other public charities. IRS has recognized that while the majority of tax-exempt organizations are trying to comply with tax law, a significant compliance challenge involves the use of donor-advised funds and supporting organizations in abusive arrangements benefiting individuals or organizations other than charities. Concerns about these abuses have led

¹Charities, recognized by Internal Revenue Code (IRC) section 501(c)(3), are exempt from paying income taxes on the funds collected for charitable purposes. Charitable purposes include serving the poor and distressed; advancing religious, educational, and scientific endeavors; protecting various human and civil rights; and addressing various societal problems. Contributions to charities are tax deductible under IRC section 170. See glossary for terms used throughout this report.

²The most recent IRS estimate available at the time of our review was for tax year 2002. We have converted IRS's reported dollar amounts to 2005 constant dollars.

³The term donor-advised funds has been used to refer to both the individual accounts donors establish, as well as the charities that maintain these accounts. For this report, we will be using the terms donor-advised funds or donor-advised fund accounts to refer to the accounts that donors establish, unless otherwise noted.

to proposed legislation imposing requirements on the operation of donor-advised funds and supporting organizations.

As requested, we are providing information on (1) federal laws and regulations regarding donor-advised funds and supporting organizations, as compared to private foundations;⁴ (2) financial and organizational characteristics, such as loan recipients, of donor-advised funds, supporting organizations, and private foundations, to the extent data are available; and (3) types of potential or actual noncompliance and promotion methods involving donor-advised funds and supporting organizations and the challenges identifying them. In addition, we agreed to provide information about noncash contribution valuation methods and marketing methods involving donor-advised funds and supporting organizations, which are discussed in appendixes III and IV.

To compare current federal laws and regulations for donor-advised funds and supporting organizations to those for private foundations, we reviewed the Internal Revenue Code (IRC), Department of the Treasury regulations, and IRS publications as they related to the purpose and operation of these entities. To determine financial and organizational characteristics of donor-advised funds, supporting organizations, and private foundations, we analyzed IRS Forms 990 and 990-PF⁵ data, as well as reviewed survey data that external organizations collected on donor-advised funds. Unless otherwise noted, tax year 2003 was the most recent year of data available at the time of our analysis. We converted 2003 dollar amounts to 2005 constant dollars. To identify types of noncompliance and promotion methods involving donor-advised funds and supporting organizations, we reviewed documents from IRS as well as from our literature search. For each objective, we spoke to various IRS managers and individuals knowledgeable about the tax-exempt community. We conducted our review from July 2005 through May 2006 in accordance with generally accepted government auditing standards.

⁴Private foundations are defined by IRC as section 501(c)(3) domestic or foreign tax-exempt organizations except those specifically excluded from the definition by section 509(a), including universities, churches, and hospitals, and similar organizations that meet a public support test or that support one of these organizations.

⁵IRS Forms 990 and 990-PF are federal information returns filed annually by tax-exempt public charities, such as supporting organizations, and private foundations, respectively. Information reported on these returns includes assets held, contributions received, and grants paid.

Results in Brief

Although donor-advised funds, supporting organizations, and private foundations are all tax-exempt, charitable-giving vehicles, federal tax laws and regulations treat them differently. In general, donors who establish donor-advised funds and supporting organizations have less control over the use of the charitable assets than those who establish private foundations, but they generally incur less administrative burden, receive less IRS oversight, have fewer limits in claiming charitable tax deductions, and have fewer reporting requirements. Donor-advised funds, unlike supporting organizations and private foundations, are charitable-giving vehicles rather than entities and are not defined under federal law. Supporting organizations fall in between a donor-advised fund and a private foundation in terms of restrictions and sanctions versus control over the use of the charitable assets. The level of control that the supported charity has over the supporting organization varies, depending on the type of relationship between the two entities. Unlike donor-advised funds and supporting organizations, private foundations are not public charities. They also face more types of taxes and requirements, such as in annual reporting, making investments, and paying out funds.

Donor-advised funds hold billions of dollars in assets, and supporting organizations and private foundations hold hundreds of billions of dollars in assets. However, IRS data on donor-advised funds are limited because although organizations that maintain donor-advised funds are to file a Form 990 that includes financial data for all organizational activities, including for donor-advised funds, data on these funds are not readily identified from the form because these data are not separately reported. Limited data on donor-advised funds are available from annual surveys by *The Chronicle of Philanthropy*, even though these data are incomplete and only represent those who voluntarily responded.⁶ For 2003, the 90 survey respondents reported that their donor-advised fund accounts held over \$11.9 billion in assets and distributed over \$2.2 billion to charities. Data from Forms 990 and 990-PF for 2003 showed differences between supporting organizations and private foundations. For example, in 2003, supporting organizations held over \$239.4 billion in assets and paid over

⁶*The Chronicle of Philanthropy* is a newspaper that publishes articles about the tax-exempt sector and is a source cited by IRS and others on the tax-exempt sector. Its most recent survey of donor-advised funds collected 2005 data, but in order to compare the data to that for supporting organizations, we used 2003 survey data that we adjusted to 2005 constant dollars. Results from this survey cannot be interpreted as being representative of all donor-advised funds.

\$10.7 billion in grants.⁷ Private foundations held over \$449.5 billion in assets in 2003 and paid over \$31.0 billion in grants. Certain other characteristics cannot be reliably determined from Form 990. For example, supporting organizations are not required to compute and report a “payout” rate equivalent to that for private foundations. Questions have arisen about how much and how often supporting organizations pay out to charities because, like private foundations, some supporting organizations can be used to accumulate contributions before distributing the money to charity. Further, other organizational characteristics, such as detailed information on loan recipients and supported organizations’ identification numbers, are not readily identified from the Form 990. IRS revised the Form 990 for 2003 to include whether the Form 990 filer maintains donor-advised funds, and for 2005, the type of supporting organization in terms of its relationship to its supported organization. IRS is considering other Form 990 revisions for donor-advised funds and supporting organizations, but plans for making revisions are preliminary.

Through examinations, IRS is finding evidence that some donors or related parties are exerting excess control over or receiving undue benefits from a donor-advised fund or supporting organization. For example, some donors to donor-advised funds and supporting organizations participate in schemes which allow them to regain their contribution, thus giving them a tax deduction on assets that did not actually go to charity. These examinations were not intended to be a statistically representative sample and even when finished will not allow IRS to estimate the magnitude of noncompliance involving donor-advised funds and supporting organizations. Although the examinations have produced strong evidence of abusive schemes involving excess control and undue benefits, IRS faces challenges when identifying and examining noncompliance, namely the difficulty of gathering evidence on the facts and circumstances of some cases. IRS is also challenged by cases in which a donor-advised fund or supporting organization is compliant because no law or regulation is violated, but engage in activities that do not seem to benefit charity. For example, under certain circumstances, a market rate loan made to a

⁷Beyond grants, supporting organizations can also provide support through other means, such as providing direct services. At the time of our analysis, the most recent data available were from 2003. For data that IRS did not transcribe, such as amount of grants paid for supporting organizations, we obtained the data from GuideStar. GuideStar is a nonprofit organization that transcribes data from Form 990 into searchable databases. IRS has not assessed in detail the quality of GuideStar’s data, but did include quality control provisions in its contract with GuideStar.

donor, officer, or director from a supporting organization may not violate legal requirements applicable to public charities even though it may appear to be a conflict of interest and have no benefit to charity. Some abusive schemes are instigated or facilitated by entities or individuals, such as attorneys, accountants, and financial planners, who promote the schemes. Because of the potentially criminal and obscure nature of their activities, these entities and individuals are often difficult to identify and investigate, which adds to the challenges in IRS's examinations.

Given the concerns about how much and how often donor-advised funds and supporting organizations are paying out their assets to charities, this report suggests that Congress should consider directing IRS to revise the Form 990 to collect sufficient information so that a consistent payout rate can be calculated for both types of charitable-giving vehicles. This information could help inform decisions about whether to adopt a minimum payout requirement and if so, whether the required rate should be adjusted over time. To help IRS make these revisions, Congress should direct IRS about the types of support that should be included in the payout rate, as it has for private foundations. In addition, given the lack of data from the Form 990 to be used to determine certain characteristics of donor-advised funds and supporting organizations and the concerns about noncompliance involving these charitable-giving vehicles, we are making recommendations to IRS on collecting better data on the Form 990. IRS agreed with our two recommendations to require more comprehensive reporting of donor-advised fund data and to require supporting organizations to report their supported organizations' employer identification numbers (EIN). However, IRS did not believe that it could implement our third recommendation to require reporting of loan recipients' taxpayer identification numbers (TIN) without legislative authority to protect the TINs from public disclosure.⁸ In response, we have revised our recommendation and, so that IRS can modify the Form 990 to require reporting of TINs of loan recipients from supporting organizations, we are also suggesting that Congress consider providing IRS authority to protect that information from public disclosure.

Federal Laws and Regulations Impose Fewer Requirements on Donor-Advised Funds and Supporting Organizations and Their Donors, but Allow Donors Less Control Compared to Private Foundations

In recent years, donor-advised funds have become popular charitable-giving vehicles, and the number of supporting organizations has also continued to increase. At the same time, federal tax law generally imposes fewer restrictions and requirements on donor-advised funds and supporting organizations, but provides them and their donors less control over the use and investment of the charitable assets compared to private foundations; in fact, section 501(c)(3) and federal regulations do not specifically mention donor-advised funds.

As a general principle, the more control that a donor has over the use of the charitable contributions and assets, the more regulations and restrictions apply. Table 1 discusses how federal tax law views donor-advised funds and supporting organizations compared to private foundations across a number of variables.

Table 1: Simplified Comparison of Differences and Similarities in Federal Tax Laws for Donor-Advised Funds, Supporting Organizations, and Private Foundations

	Donor-advised funds	Supporting organizations	Private foundations
Tax code treatment	Although not statutorily defined, part of a public charity that operates funds as separately identified accounts.	Public charities that carry out their charitable purpose by supporting other public charities.	Charities that do not qualify as public charities.
Filing requirement	Fund administrators must apply for tax-exempt status and annually file Form 990 if annual gross receipts are over \$25,000, indicating if they have separate accounts (on which separate Forms 990 are not required).	Must apply for exempt status as a supporting organization. Must annually file Form 990 if annual gross receipts are over \$25,000.	Must apply for exempt status as a private foundation. Must annually file Form 990-PF as well as schedules on the use, distribution, and investment of funds.
Donor control	Donors cannot have control but may advise on use of funds.	Donors can be involved with boards but should not directly or indirectly control the boards.	Donors and foundation's board have absolute control, such as hiring staff and choosing charities to support.
Donor tax deductions	Follows rules for public charities. See "Supporting organizations."	Donors may deduct up to 50 percent of adjusted gross income for cash donations and up to 30 percent of adjusted gross income for donations of capital gain property at fair market value.	Donors may deduct up to 30 percent of adjusted gross income for donations of cash and up to 20 percent of adjusted gross income on capital gain property at cost basis.
Excise taxation	Follows rules for public charities. See "Supporting organizations."	Subject to two excise taxes.	Subject to six excise taxes.
Payout rules	None.	None.	Must meet annual minimum payout requirement.
Association with foreign entities	Follows rules for public charities. See "Supporting organizations."	May make grants to foreign organizations, but must ensure that funds are used for charitable purposes.	Must follow more detailed rules than for public charities, including expenditure responsibility process.

Source: GAO analysis of Internal Revenue Code, Treasury Regulations, and IRS Forms and Publications.

Among the three types of charitable-giving vehicles, donor-advised funds allow donors to create a long-term vehicle for supporting charities with relatively less administrative burden because the fund is managed by a third party. Furthermore, donor-advised funds are not required to file separate tax returns, file for tax-exempt status, or adhere to private foundation rules. The donor can make a gift and take an income tax deduction for that tax year, and at that time or later, advise which charities should receive the distribution. However, in doing so, the donor gives up control over the distribution of the gift to charities.

**Private Benefit,
Inurement, and Donor
Control Have Been
Found in Some Cases
Involving Donor-
Advised Funds and
Supporting
Organizations, with
Promoters Sometimes
Facilitating Schemes**

IRS program managers report that some donor-advised funds and supporting organizations cases highlight concerns about private benefit, inurement, and donor control. Some of these cases demonstrate clear noncompliance, allowing IRS to propose appropriate corrective actions. However, IRS is confronted with many cases that require detailed assessments of evidence, which makes addressing noncompliance challenging. Additionally, IRS contends with activities involving donor-advised funds and supporting organizations that do not violate laws or regulations, yet do not seem to benefit charities. Entities or individuals, such as financial advisers or attorneys, sometimes facilitate abusive schemes, introducing additional complexities to IRS's examination process.

Private Benefit, Inurement, and Donor Control Are Prevailing Concerns in Donor-Advised Fund and Supporting Organization Noncompliance Cases

Private Benefit and Inurement Lead to Personal Gains

Private benefit, inurement, and donor control are common concerns for IRS in examinations of potential noncompliance involving donor-advised funds and supporting organizations. IRS is unable to provide estimates about the prevalence of this noncompliance, and noncompliance in general. Thus, the examples presented are intended to illustrate known cases of private benefit and donor control, and do not represent the entire range of noncompliance.³²

Private benefit occurs when a 501(c)(3) organization is not operated or organized exclusively for exempt purposes because it serves a private rather than public interest. Because they are subject to section 501(c)(3), both donor-advised funds and supporting organizations must avoid private benefit that is more than incidental to the charitable purpose being served; if private benefit is substantial enough, it may jeopardize an organization's tax-exempt status. If the organization's assets or income are transferred to an individual who is a charity insider, the benefit is called "inurement."³³ Private benefit and inurement schemes involving donor-advised funds and supporting organizations may benefit various individuals and may vary in complexity.

IRS has encountered multiple cases of private benefit where donors to donor-advised funds are able to regain some or all of their contribution. For example, IRS has concerns about one fund offering a "loan program," where donors were able to repossess their donation, with no obligation for repayment. IRS also sees inurement cases, in which individuals other than the donor receive private benefit. For example, IRS is examining one exempt organization and donor-advised fund operated by a for-profit company. The company offered the fund as a charitable giving vehicle for its employees. The exempt organization lacked an independent board, with the president—who also served as president of the for-profit company—receiving potentially high commissions and fees from contracts with the donor-advised fund.

³²All examples in this section are from ongoing or past IRS investigations, and were described by IRS officials.

³³A charity insider is an individual such as an officer, board member, or other persons able to exercise substantial influence over a tax-exempt organization. Donors to donor-advised funds are rarely considered to be insiders, while donors to supporting organizations can be insiders, for example, if they also serve on the supported organization's board.

While donor-advised fund schemes often involve private benefit, schemes involving supporting organizations more often result in inurement and are typically more complex, according to IRS management. Schemes can involve direct payment of benefits to donors or, more indirectly, payments routed through offshore entities. One direct payment scheme, designed to benefit a donor's children, funneled school tuition payments through a supporting organization intended to support their child's school. More complex schemes enable the donor to regain his or her donation after it is routed offshore. One typical scheme begins with a donation to a supporting organization, which is then transferred to an account in an offshore investment firm controlled by a financial planner, accountant, or other knowledgeable insider working with the donor. The money is then transferred to a domestic mortgage lender, also controlled by the insider, giving the donor access to the money for use toward an interest-only mortgage. As a result, the donor benefits from a tax deduction on his or her contribution, while still retaining access to the donation. To justify the scheme, the supporting organization claims that earnings from their investment in the offshore firm will benefit charity.

Donor Control May Involve Assets or Charity Operations

Donor control arises when a donor holds authority that exceeds what is permissible for donor-advised funds or supporting organizations. Illegal control can occur when a donor or disqualified person has control over the charity's assets, operations, or governance, or the organizations receiving support.³⁴ It is possible for donor control to occur without private benefit. A donor may control a function or operation of a supporting organization or donor-advised fund without receiving benefits, according to IRS management. Donor control involving donor-advised funds and supporting organizations manifests in different ways.

Donor control of a donor-advised fund occurs when the donor oversteps his or her advisory role and retains ultimate authority over the distribution of fund assets. One IRS manager told us that, although more common in supporting organization cases, a donor-advised fund donor may also achieve control by controlling the exempt organization receiving the benefits of their donation. For example, IRS is pursuing a case where a donor-advised fund appears to be making distributions to a public charity, which is controlled by the donor-advised fund's donor. If the donor-

³⁴In order for a charitable contribution to be considered a donation eligible for a tax deduction, the donor must relinquish control of the asset. IRC section 170 defines charitable contributions and provides the rules and limits for tax deductions for individuals and corporations.

advised fund did not exist, the public charity recipient would likely be classified as a private foundation. IRS is investigating whether the charity has other support sources.

For supporting organizations, control of the organization's board or the donor's ability to designate charitable recipients can constitute donor control.³⁵ Board control can occur directly by controlling more than 50 percent of board voting power or veto power granted to disqualified persons. Alternatively, board control can occur indirectly through a disqualified person influencing board members who are not disqualified persons, according to IRS managers. Retaining access to assets can also signify direct or indirect control of a supporting organization. In one case, IRS has questioned whether or not a donor controlled the operations and investments of the supporting organization that the donor founded, although the donor did not receive private benefit. Donor control can also occur indirectly through control of an asset donated to the supporting organization. For example, in one case, IRS is concerned that a donor is continuing to collect and retain rent from building tenants after the building was donated to a supporting organization.

Other Types of Noncompliance Exist

Although private benefit, inurement, and donor control are reoccurring themes in IRS's caseload, other types of noncompliance involving donor-advised funds and supporting organizations can occur. Specifically, a supporting organization could fail to maintain a relationship with its supported organization(s).³⁶ A representative from the tax-exempt community told us of situations where charities listed as supported organizations were unaware of a purported relationship with a supporting organization. The Panel on the Nonprofit Sector also recognized this problem in its June 2005 report. Similarly, IRS managers told us that a major issue in supporting organization examinations is whether or not the organization maintains a sufficient relationship with its supported organization. Form 990 only requires that supporting organizations report the name of their supported organizations; it does not require them to report the EIN of the supported organization. IRS managers told us that

³⁵Definitions of "control" and the limits of power for disqualified persons are found in Treas. Reg. §1.509(a)-4(j)(1). Also see Rev. Rul. 80-207 for analysis of indirect influence on a board.

³⁶Because of required structures and board oversight for Type I and II supporting organizations, this problem is more likely for Type III supporting organizations.

IRS Has Various Efforts to Identify and Correct Noncompliance, but Does Not Know the Rate of Noncompliance

not knowing the EIN makes it harder for IRS staff to track the relationship between the two organizations.

IRS uses resources from a variety of units to identify and examine noncompliance involving donor-advised funds and supporting organizations. Toward these ends, IRS created two teams, one on donor-advised funds and one on supporting organizations.³⁷ As of June 2006, the donor-advised fund team had opened but had not yet closed 27 examinations, according to an IRS manager.³⁸ As of June 2006, the supporting organization team had opened 102 examinations and closed 20 of them; 18 of which were found to be noncompliant, according to IRS. IRS managers also told us that other programs—including the Tax Examination Program and the Excessive Compensation Program—have also examined and closed supporting organization cases, and are currently examining 655 supporting organizations.³⁹

Regardless of the type of noncompliance found, IRS can propose corrective actions when the evidence shows that a law or regulation has been unmistakably violated. IRS is developing criteria for proposing corrective actions for donor-advised funds as the related team finishes its examinations; many of the examinations are in the early stages. For supporting organization cases, IRS officials said, in general, they will propose a change to private foundation status for issues of donor control. Intermediate sanctions or revocation of the tax-exempt status are typically proposed for inurement cases, according to IRS.⁴⁰ Criminal charges may be brought upon individuals found to be exhibiting criminal behavior while

³⁷Each team will report on noncompliance trends and possible regulatory or legislative actions. The donor-advised fund team, which formed in 2002, plans to issue a report by the end of 2006, according to an IRS manager. The supporting organization team, which formed in 2003, told us it plans to issue reports—the first of which would be released in August 2006 and the last of which would be released at the end of fiscal year 2007—on each of the three waves of cases they are investigating.

³⁸The 27 examination cases involved 27 tax returns for 22 different organizations.

³⁹Between October 1, 2001, and September 30, 2005, these other IRS units have closed 715 cases involving supporting organizations, 400 of which were found to be noncompliant. For fiscal year 2006, 94 cases have been closed so far; 64 of which were found to be noncompliant.

⁴⁰“Intermediate sanctions” in this context generally refers to excise taxes paid by a disqualified person receiving private benefit or a charity manager with knowledge of a scheme, as defined in IRC section 4958. IRS officials said that, in the most egregious cases, IRS may recommend intermediate sanctions in conjunction with revocation of the supporting organization’s tax-exempt status.

participating in abusive schemes, and may occur in conjunction with corrective actions resulting from examinations. In cases where the donor-advised fund or supporting organization is believed to be beneficial overall but needs correction in order to be fully compliant, IRS managers told us they may also initiate a closing agreement, which provides a set of requirements intended to correct flaws in the donor-advised fund or supporting organization structure or operations.

For various reasons, IRS does not know the overall rate of noncompliance or the prevalence of different forms of noncompliance involving donor-advised funds and supporting organizations. First, IRS did not use a random sample to identify cases for examination. Instead, it used methods that led to examining the most egregious noncompliance schemes. For example, the manager for the donor-advised fund team told us it selected cases for examination based on large asset size or other unusual characteristics, such as high compensation or high fees.⁴¹ Supporting organizations cases were selected based on referrals from other IRS units, according to the team's manager. Second, IRS has no established population of donor-advised funds for which to estimate a noncompliance rate. An IRS manager said IRS is unable to identify the population because exempt organizations have not been required to report their use of donor-advised funds, which prevents IRS from employing statistical sampling methodology to estimate donor-advised fund noncompliance. Third, examinations by IRS's teams are relatively new; examinations began in 2005 for donor-advised funds and began in 2004 for supporting organizations, according to IRS managers.⁴²

IRS Faces Challenges in Addressing Noncompliance Involving Donor-Advised Funds and Supporting Organizations

Not all cases involving donor-advised funds and supporting organizations are clear; IRS faces challenges in identifying and examining potential noncompliance. In part, these challenges are due to uncertainty about whether the evidence unequivocally points to noncompliance, and to the difficulty in exhaustively collecting evidence on the facts and circumstances of a case.

⁴¹IRS identified donor-advised funds for potential examination using (1) data from IRS's Rulings and Agreements office, which assesses organizations' applications for tax-exempt status, and (2) outside sources, including *The Chronicle of Philanthropy*.

⁴²Although the donor-advised fund and supporting organizations teams began in 2002 and 2003, respectively, examinations did not begin until later.

To evaluate facts and circumstances, IRS managers said that agents may evaluate minutes of meetings, correspondence among trustees, contracts or agreements on loans or rent, news articles, or the organization's trust document. Although exempt organizations must maintain documentation that they operate exclusively for exempt purposes, the existence and quality of these documents may differ among organizations, according to IRS managers. Therefore, IRS may need to collect evidence that is time- or resource-intensive to uncover. Evidence that does not readily exist or that is difficult to uncover, combined with the practical limits of the examination process, make some noncompliance nearly impossible to detect, as the following examples illustrate.

- In determining influence on or control of a board, regulations define permissible relationships between disqualified persons and supporting organization boards. Despite regulatory guidance, IRS is unable to identify all noncompliant situations because it cannot always identify influence on board members by disqualified persons, especially when attempting to identify a disqualified person's indirect influence. Nomination of a majority of board members by a disqualified person may signify this influence, but IRS cannot consistently track the origination of a board nomination. Only in some cases are trust documents and meeting minutes available that may document the nomination process, according to IRS. Additionally, IRS may have difficulty identifying a disqualified person's indirect influence on a board when this influence may occur in private conversations.
- It may also be challenging to find evidence that ensures that donor-advised funds are operating on "donor advice" rather than "donor control." To establish that donors are not exercising undue control, IRS may examine the process by which a donor makes a funding recommendation, according to the manager of IRS's donor-advised fund team. Specifically, IRS managers said this examination could include verification of an independent board, the process by which the fund operator investigates donor recommendations or provides documents that show that a donor's recommendations are not all accepted. However, similar to the challenges of identifying board control, IRS may not be able to detect subtle coercion occurring in payout decisions.
- Detecting control of assets may also be difficult. For example, a donor may contribute a large portion of interest in a business partnership to a

supporting organization.⁴³ The donor, serving as the business's general partner, retains some ownership of the partnership and has a management responsibility or controls voting stock. According to an IRS manager, unless the supporting organization has other assets, this situation would likely allow the donor to have effective control over the assets of the supporting organization. In some situations, the business may claim that the general partner lacks controlling power, in which case IRS managers said examiners must rely on available evidence, such as partnership agreements, to determine the donor/partner's control over the business. Once again, evidence of more subtle control may not be available or practical for IRS to pursue.

Some Compliant Activities Involving Donor-Advised Funds and Supporting Organizations Do Not Seem to Benefit Charity, Thus Introducing Areas for Potential Future Scrutiny

Not all cases involving donor-advised funds and supporting organizations are clear cases of private benefit, inurement, or donor control, or involve the challenges of gathering evidence. IRS managers said they encounter scenarios where no statute or regulation was violated, but where activities involving donor-advised funds or supporting organizations do not seem to benefit charity. In these situations, noncompliance cannot be alleged, but IRS may still question an organization's or individual's charitable purposes. A general lack of data as well as a lack of legal definitions and regulations for donor-advised funds contribute to these uncertainties for IRS, which have prompted both IRS and Congress to consider different solutions for reform, as the following examples illustrate.

- One IRS manager told us that IRS is uncertain about whether or not donor-advised funds with low payout rates are supporting charitable purposes. No laws or regulations require annual minimum payouts to charities from donor-advised funds, but according to IRS management, idle assets are unlikely to result in benefits. Conversely, a donor-advised fund may be idle in paying out to build an endowment. If a supporting organization has a low payout rate, however, IRS said this can sometimes signify that it is not fulfilling its requirement. Legislation has been introduced in Congress to impose a minimum payout on donor-advised funds and supporting organizations. As of early July 2006, legislation on this issue had not passed.
- IRS managers told us that examiners have discovered loans made from a supporting organization to a donor or insider. Loans made by public

⁴³ A donor-advised fund can receive a donation of interest in a partnership, but the legal analysis required to determine donor control differs from that for a supporting organization.

charities to officers, directors, donors, and others are legal, provided that they are repaid and not made at terms lower than the market rate.⁴⁴ According to IRS, charities could justify these loans as an investment. However, these loans may carry risk or introduce a conflict of interest. For example, if a borrower has some form of control over the organization, such as that of a board member or executive, it is less likely that the organization will take legal action if the loan is not repaid. Also, loans may prevent assets from being paid out to charitable purposes. Furthermore, if a loan is made as part of an employee compensation package, in some cases it may be classified as an excess benefit under IRC section 4958, according to IRS management. Additionally, these loans may signify control by disqualified persons. Even if a loan's interest rate is reasonable, or the borrower is not an employee or in control of the organization, the terms of the loan may give a borrower other benefits, thus making a case that the organization serves private rather than public purposes. In recognition of such potential improprieties, 19 states have banned such loans, according to *The Chronicle of Philanthropy*. As part of a broader study of executive compensation at public charities, IRS is examining loans made to insiders, but is not specifically focusing on supporting organizations.

Promoters May Aid in Abusive Schemes, and May Be Difficult to Identify and Examine

In addition to examining donor-advised funds, supporting organizations, and donors, IRS investigates the promoters—creators and facilitators of abusive schemes. Some abusive schemes are organized or participated in by professionals or entities who work in concert with the donor. Identifying and examining the roles of these professionals or entities can be difficult and therefore may exacerbate the challenges in examining donor-advised fund and supporting organizations cases.

A promoter is an individual or entity that organizes or assists in the organization of a partnership, trust, investment plan, or any other arrangement to be sold to a third party and designed to be used or is actually used in obtaining illegal tax benefits.⁴⁵ Accountants, financial planners, attorneys, community foundations, and tax preparers could

⁴⁴IRS encounters transactions between supporting organizations and donors that are labeled as "loans" but do not result in repayment. These transactions are likely cases of inurement and are a separate issue from true loans, which result in repayment. As described in IRC section 4941, loans made from a private foundation to a disqualified person are subject to excise taxation.

⁴⁵The definition of promoters is for purposes of IRC section 6700.

serve as promoters, and may not just be involved in schemes involving exempt organizations. Cases involving promoters address both the material used to promote noncompliance, which must adhere to tax law, as well as the actual activities implementing a scheme.⁴⁶ Because promoters may be committing fraud, promoters could face criminal charges. See appendix IV for a discussion of materials and methods for publicizing donor-advised funds and supporting organizations which are not intended to lead to abusive schemes.

According to IRS managers, some schemes, particularly those benefiting high-income donors, originate with a financial planner, accountant, or lawyer. Other promoters may play a role in facilitating schemes, such as the mortgage inurement scheme previously described in this report. According to the manager of IRS's donor-advised fund team, promoters are typically more involved in schemes involving supporting organizations than donor-advised funds due to the complexity of supporting organizations' schemes.

For some cases IRS is able to identify the promoter, noncompliant material, and transactions that promote noncompliance.⁴⁷ For example, material from a financial planner offered a hypothetical estate plan proposing that a supporting organization hold a wealthy donor's personal assets, thus facilitating a reduction in estate taxes upon the donor's death. The plan proposed transferring land owned by the donor to the supporting organization, who would offer the sale of the land to the donor's heirs at about 10 percent of its fair market value. Furthermore, the plan proposed that the supporting organization also lease the estate assets back to the donor's business. If the plan were carried out, inurement, private benefit, excess benefit, and donor control would be significant legal concerns.

However, according to IRS managers identifying and investigating promoters is often challenging. IRS managers said they rely on referrals and Internet searches to find promoters. Although some promoters advertise on the Internet, they may sometimes only share details about the promotion in conversations with a donor. IRS's donor-advised fund and supporting organization teams have investigated nine promoters involved in potentially abusive schemes, according to IRS managers. In addition to

⁴⁶Promoters are subject to laws prohibiting the promotion of abusive tax structures, covered in IRC sections 6700 and 6701.

⁴⁷IRS is unable to determine the extent of the role of promoters in noncompliance.

the work of the issue teams, IRS's civil Lead Development Center is tasked with identifying promoters and coordinating promoter investigations. IRS managers told us that once IRS identifies potential promoters, examiners must seek information that is typically carefully hidden among complex transactions involving multiple entities. This requires that IRS carefully craft document requests and summonses, which can be a lengthy process. Furthermore, once IRS refines its examination process to target certain schemes, promoters quickly alter their approaches.

Finally, like some of the cases described earlier in this section, some marketing material may not violate a law or regulation, but may have a questionable purpose which may indicate potential noncompliance by misleading donors with incomplete information. This may occur when marketing material may be providing incomplete information on the limits of donor-advised funds and supporting organizations versus private foundations. We found examples of Web sites that describe a donor-advised fund or supporting organization as a giving option with all the benefits and advantages of a private foundation, which may mislead potential donors into believing they can retain control over their donation.

Conclusion

Donor-advised funds, supporting organizations, and private foundations are vehicles for charitable giving. Donors can use these approaches for long-term giving or to accumulate assets to address some larger need. They also may create donor-advised funds or supporting organizations to avoid the costs, burdens, excise taxes, and restrictions associated with private foundations.

However, concerns have been expressed about the potential for abuses by those who create and operate donor-advised funds and supporting organizations, prompting legislative proposals to deter abuses. IRS has found examples of abuses in these funds and organizations involving those who do not give up control of their donations and who benefit privately at the expense of the charitable interest. Although IRS has efforts to focus on such abuses, IRS examiners lack sufficient data, which complicates efforts to identify and address the noncompliance.

Congress is considering proposals to require donor-advised funds and supporting organizations to annually pay out a certain percentage of their assets to serve charities, which would roughly mirror the requirement for private foundations. However, no defined way exists to calculate a payout rate for these funds and these organizations, and current Form 990 data do not allow for full or consistent analyses of the payout rate for donor-advised funds or supporting organizations. Guidance is needed on what

types of support should be included in a payout rate so that the Form 990 collects the necessary data. If a payout rate requirement is not adopted, these Form 990 requirements would provide data to inform future congressional decisions about whether a requirement should be instituted. If a payout rate is adopted, the data would help in tracking compliance and determining whether the requirement may need to be adjusted.

Collecting payout information on the Form 990, however, would not be possible for donor-advised funds due to limitations in annual Form 990 reporting. Starting in tax year 2003, IRS has been able to identify Forms 990 that report donor-advised fund activity. However, IRS will not have data that separate the fund activity from other activity. Adding a requirement to separately report the donor-advised fund activity from other activity on the Form 990 would allow IRS to check the payout rate as well as other fund activity that looks suspicious.

IRS also has concerns with supporting organizations that do not support their supported organizations or that make loans to individuals or organizations. IRS would be better able to track the flow of funds to the charities to be supported and loan recipients if it knew their TINs, which are generally Social Security numbers for individuals or EINs for organizations. Collecting the TINs of loan recipients raises concerns about the potential costs and burdens and the protection of the TINs from unauthorized use. IRS could address these concerns by only requiring TIN reporting for loans above a certain dollar threshold and by not making the information publicly available. If the Form 990 is changed to separately report data on donor-advised fund activity, IRS should consider extending this TIN reporting to donor-advised funds.

Matters for Congressional Consideration

Given the concerns about payout rates for both donor-advised funds and supporting organizations, Congress should consider directing IRS to revise the Form 990 to collect sufficient information so that a consistent payout rate can be calculated for both types of charitable-giving vehicles. This information could help inform decisions about whether to adopt a minimum payout requirement and if any required rate should be adjusted. To help IRS in making these revisions, Congress should direct IRS about the types of support that should be included, as it has for private foundations. In addition, so that IRS can modify the Form 990 to require TINs of loan recipients from supporting organizations, Congress should also consider providing IRS authority to protect that information from public disclosure.