



Prohibited Benefits from Donor-Advised Funds

Summary: Donors and advisors are prohibited from receiving more than incidental benefits from grants made from their advised funds. Penalties apply to those who receive a prohibited benefit, to those who recommended the grant, and, in some situations, to fund managers who approve the recommendation.

Effective Date: Tax years beginning after August 17, 2006.

Who is prohibited from receiving a benefit? 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 such fund or account. 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.

What is a thirty-five percent controlled entity? Any entity 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? The penalties imposed by this section apply when the donor, advisor, or a related party receive more than incidental benefits from a grant from their advised funds. The provision also penalizes 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.

What are the penalties? Individuals who recommend or benefit from a prohibited distribution must pay a tax 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 tax equal to 10 percent of the benefit.

How does this relate to the new 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 enable the donor to pay a 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 pay the donor's child's tuition.

Are the 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 penalty must be paid to the government, while the government receives only 25 percent of the payment in the case of the section 4958 penalty 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 could be penalized under either section 4958 or section 4967, the section 4958 penalty will apply.

What is an incidental benefit? We plan 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". As an example, 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 would be 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 that supports a home for the elderly in which a dependent parent of the donor is a resident and where the charity distributes funds to that home according to a formula because it is a member organization.

Beyond these examples, it may be difficult to determine where the line between an incidental benefit and a prohibited benefit lies. We recommend that you consult with legal counsel before approving a distribution if doing so will result in a tangible benefit to the 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. Good 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% 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 for inflation and change annually.

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.

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.