

“I’D GLADLY PAY YOU TUESDAY FOR A [TAX  
DEDUCTION] TODAY”: DONOR-ADVISED FUNDS AND  
THE DEFERRAL OF CHARITY

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*In recent years, donor-advised funds have become an increasingly popular vehicle for charitable giving. In part, their popularity can be traced to a disconnect in the law: donor-advised funds look in many ways like private foundations, but the tax law treats them as public charities. This disconnect is advantageous to donors. Because Congress was worried about wealthy individuals’ ability to take advantage of the control they can exercise over private foundations, it imposed a series of additional tax rules on private foundations. These rules, among other things, limit the deductibility of donations to private foundations, require that private foundations make minimum annual distributions, and require a significant level of transparency from private foundations.*

*The disconnect between donor-advised funds functioning like private foundations but being classified as public charities means that donors can use donor-advised funds to circumvent the more onerous regulations governing private foundations. Through a donor-advised fund, a taxpayer can take an immediate deduction for a charitable donation with no requirement that the fund distribute any of its assets. The taxpayer enjoys a significant level of control over when and to whom the donor-advised fund eventually distributes the money. Further, the taxpayer enjoys complete privacy: as a public charity, the donor-advised fund does not have to disclose to the public what it does with its money.*

*Donor-advised funds qualify as public charities because they are not individual entities. Rather, each fund is a segregated account within a larger sponsoring organization. This structure causes the donor base to be diverse, which, in*

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*turn, is how these funds qualify as public charities. Donor-advised funds do not have to provide a way for donors to circumvent the private foundations rules, though. This Article proposes that donor-advised funds be required to qualify as public charities individually rather than at the sponsoring organization level. Doing so will ensure that the rules meant to prevent charitable abuses will look at donor-advised funds' functions, not their forms.*

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#### I. INTRODUCTION

The initial public offering of GoPro made founder and chief executive officer Nicholas Woodman wealthy: after the company went public, his net worth was about \$3 billion.<sup>1</sup> In late 2014, Woodman announced that he would give about \$500 million of his stock to charity.<sup>2</sup>

This type of charitable pledge by a founder is relatively common.<sup>3</sup> It signals to the public that the company and its executives “take their

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1. David Gelles, *How Tech Billionaires Hack Their Taxes With a Philanthropic Loophole*, N.Y. TIMES (Aug. 3, 2018), <https://www.nytimes.com/2018/08/03/business/donor-advised-funds-tech-tax.html> [https://perma.cc/QCV3-SWZS].

2. *Id.*

3. See Natasha Frost & Alison Griswold, *WeWork's Co-Founders Must Give \$1 Billion to Charity Over 10 Years or Lose Some Control of the Company*, QUARTZ

philanthropic responsibility seriously.”<sup>4</sup> Beyond philanthropy, donating shares in a newly public company can provide significant tax benefits to individuals.<sup>5</sup>

In the first instance, the donor can take a charitable deduction for the fair market value of the stock she donates.<sup>6</sup> In the initial public offering context, there is an even more important consequence: a charitable contribution is not a realization event and the donor does not pay taxes on her gain on the appreciated property.<sup>7</sup> In other words, if Woodman had a basis of \$1 million in the stock he donated and he sold that stock in order to make a charitable gift, he would realize \$499 million of gain and would pay taxes on that amount.<sup>8</sup> By donating the stock to charity instead, he not only received a \$500 million deduction but he also never had to pay taxes on the stock’s appreciation.

Historically, Woodman would have chosen one of two routes for his philanthropy: he either would have donated the money to a public charity or to a private foundation.<sup>9</sup> Woodman chose to go a third route: he donated his stock to a donor-advised fund.<sup>10</sup>

In recent years the popularity of donor-advised funds has exploded, notably (though not exclusively) with Silicon Valley billionaires.<sup>11</sup> The appeal of donor-advised funds is easy to understand: they provide donors with the expedited deduction and control of private foundations while simultaneously providing the privacy and higher deduction limitations of public charities.<sup>12</sup>

However, these advantages to donors may be disadvantageous to the public at large, allowing donors to circumvent rules Congress enacted to protect the public and charitable institutions.<sup>13</sup> Half a decade after Woodman made his charitable contribution to the Silicon Valley Community Foundation, the sponsoring organization of the donor-advised fund Woodman set up, there is almost no trace of the

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(Aug. 15, 2019), <https://qz.com/1687628/adam-neumanns-control-of-wework-is-tied-to-his-charitable-pledge/> [<https://perma.cc/D7S5-BWUS>].

4. *Id.*

5. *Id.*

6. *See* Treas. Reg. § 1.170A-1(a), (c)(1) (as amended in 2019).

7. Jeffrey L. Kwall, *When Should Asset Appreciation Be Taxed?: The Case for A Disposition Standard of Realization*, 86 *IND. L.J.* 77, 106 (2011) (“Under current law, a gratuitous transfer of appreciated property does not trigger a taxable gain to the donor.”).

8. *See* I.R.C. § 1001(a) (2018).

9. *See infra* notes 57–62 and accompanying text.

10. Gelles, *supra* note 1.

11. *Id.* (“That [donor-advised funds] have become so popular with Silicon Valley billionaires has only added to their intrigue.”).

12. *See infra* notes 95–102 and accompanying text.

13. Gelles, *supra* note 1 (“[T]here is concern that [donor-advised funds] — a dream vehicle for the overnight wealthy — may prove to be another instance of techno-optimists disrupting a system with unintended consequences.”).

foundation or the \$500 million he donated.<sup>14</sup> “The foundation has no website and has not listed its areas of focus, and it is not known what—if any—significant grants it has made to nonprofits.”<sup>15</sup>

This Article addresses the disconnect between donor-advised funds’ function as quasi-private foundations and their legal status as public charities. Part II lays out both the history and the theory underlying charitable deductions. Part III proceeds to look at the tax rules that apply to private foundations and how they differ from the rules that apply to public charities. This Part explains the reasons why Congress decided it needed to impose more restrictive rules on private foundations than it did on public charities.

Part IV introduces donor-advised funds. This Part explores their development and how they function. Further, this Part discusses how they managed to fit into the gaps between public charities and private foundations and what they have in common with each category of charitable institution. Part V then builds on that introduction, explaining how donor-advised funds allow taxpayers to circumvent the rules meant to cabin donations to nonoperating charities.

Part VI goes through a number of proposals intended to address the problems of donor-advised funds. While these proposals have addressed some of the problems, no proposal has comprehensively dealt with blocking the slippage between donor-advised funds and private foundations. As a result, Part VII proposes a solution: that tax law treat donor-advised funds as separate entities. Doing so will require each fund to qualify as a public charity on its own, not as part of a larger group of funds. Looking at each fund as a separate entity would align the policy goals of private foundations with the reality of donor-advised funds. At the same time, it would not prevent a donor-advised fund from qualifying as a public charity; it would merely require that fund to qualify for public charity status on its own.

## II. THE CHARITABLE DEDUCTION

The federal income tax exemption for charitable organizations is as old as the modern income tax itself. Congress included this charitable tax exemption in the abortive Wilson-Gorman Tariff Act of 1894.<sup>16</sup> The Supreme Court held the 1894 income tax to be

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14. *Id.*

15. *Id.*

16. Eric C. Chaffee, *Collaboration Theory: A Theory of the Charitable Tax-Exempt Nonprofit Corporation*, 49 U.C. DAVIS L. REV. 1719, 1735 (2016). While the Civil War income tax did not include any kind of charitable exemption, it also did not need to. With a small handful of exemptions—none of which qualified as charitable—the Civil War income tax only taxed individuals, not entities. David J. Herzig & Samuel D. Brunson, *Let Prophets Be (Non) Profits*, 52 WAKE FOREST L. REV. 1111, 1128 (2017) (“[T]he [Civil War] income tax treated corporations as pass-through entities, and shareholders had to pay taxes on their pro rata share of corporate income, whether or not the corporation paid out a dividend.”).

unconstitutional before it went into effect.<sup>17</sup> But in 1913, after a constitutional amendment, Congress enacted a new federal income tax.<sup>18</sup> The new income tax again included an exemption for charities.<sup>19</sup>

The charitable exemption makes up only one side of today's tax treatment of tax-exempt charities, though. The other side is a deduction for taxpayers who donate to charity. This deduction did not enter the tax law until 1917,<sup>20</sup> four years into the life of the income tax and more than twenty years after Congress first exempted charitable organizations from income taxation.

While the charitable deduction was not implemented until 1917, Congress had previously considered the idea. The 1894 income tax, for instance, included a *corporate* charitable deduction.<sup>21</sup> And in 1913, Representative John Rogers proposed that the income tax include a charitable deduction for individuals.<sup>22</sup>

Representative Rogers situated his proposed charitable deduction within other deductions the tax law used to ascertain net income.<sup>23</sup> While he did not explicitly say that a taxpayer's net income should not include amounts donated to charity, he strongly implied as much. He went on to justify the exemption by arguing against any "curtailment imposed by [the federal income tax] . . . upon the benevolent members of the community."<sup>24</sup> Ultimately, Rogers said if a taxpayer wants to make a charitable gift, she should be encouraged to do it, not penalized, and a deduction would provide just that encouragement.<sup>25</sup> The House considered the Rogers amendment and rejected it.<sup>26</sup>

Four years later, Senator Henry Hollis reintroduced the idea of a charitable deduction using a remarkably similar justification: to encourage the wealthy to make contributions to charitable institutions.<sup>27</sup> This time, though, the charitable deduction successfully made its way into the tax law. What happened between 1913 and 1917 that convinced Congress to change its mind?

World War I happened. When first enacted in 1913, the federal income tax affected very few Americans, and even those affected paid very little. Originally, the highest combined normal and surtax rate

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17. *Pollock v. Farmers' Loan & Tr. Co.*, 158 U.S. 601, 637 (1895).

18. Chaffee, *supra* note 16, at 1736.

19. Revenue Act of 1913, ch. 16, § II(G), 38 Stat. 114, 172.

20. Chaffee, *supra* note 16, at 1736.

21. Carol A. Jones, Note, *TAX LAW—Hernandez v. Comm'r: The Supreme Court Forces A Square Peg into A Round Hole*, 25 WAKE FOREST L. REV. 917, 924 n.69 (1990).

22. 50 CONG. REC. 1259 (1913) (statement of Rep. Rogers).

23. *Id.*

24. *Id.*

25. *Id.*

26. 50 CONG. REC. 1259. The Congressional Record merely states that the amendment was rejected, without any explanation of why.

27. 55 CONG. REC. 6728 (1917) (statement of Sen. Hollis).

was 7 percent, and the tax exempted a married couple's first \$4000 of income.<sup>28</sup> With the average adult man earning \$578 per year, the tax only reached about 2 percent of American households.<sup>29</sup>

World War I required a drastic increase in federal revenue, leading Congress to increase the top combined income and surtax rate to 67 percent in 1917.<sup>30</sup> Though tax rates had rocketed up, the income tax had not transformed from a class to a mass tax<sup>31</sup>—in 1918, only about 15 percent of American families paid any federal income tax.<sup>32</sup>

As Congress raised the tax rate, it worried about some collateral consequences of increased taxation, including the consequences to charities. Senator Hollis argued that people gave to charity out of their surplus. After they have done everything else they wanted to do—after they have educated their children and traveled and spent their money on everything they really want or think they want—then, if they have something left over, they would contribute it to a college or to the Red Cross or for some scientific purposes.<sup>33</sup>

If taxes cut into that surplus, charitable giving would be the first expense the wealthy would jettison.<sup>34</sup> But Senator Hollis believed that a deduction for charitable giving would “permit a wealthy man to contribute to charitable, educational, and scientific institutions,” notwithstanding the high tax rate.<sup>35</sup>

The 1917 law did not allow taxpayers an unlimited charitable deduction. Senator Hollis proposed that the deductible amount not exceed 20 percent of a taxpayer's net income.<sup>36</sup> Senator Furnifold Simmons replied that he was amenable to a charitable deduction, provided they lowered the ceiling to 15 percent.<sup>37</sup>

When the bill passed, it provided for the deductibility of “[c]ontributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the

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28. STEVEN A. BANK ET AL., *WAR AND TAXES* 52 (2008).

29. *Id.*

30. Lawrence A. Zelenak, *Leaving It Up to Treasury: Congressional Abdication on Major Policy Issues in the Early Years of the Income Tax*, 81 *LAW & CONTEMP. PROBS.* 137, 159 (2018).

31. JOSEPH J. THORNDIKE, *THEIR FAIR SHARE: TAXING THE RICH IN THE AGE OF FDR* 231 (2013). That shift occurred with World War II, by the end of which more than 90 percent of Americans filed tax returns. *Id.*

32. *Id.* at 5–6.

33. 55 *CONG. REC.* 6728 (1917) (statement of Sen. Hollis).

34. *Id.*

35. *Id.* Interestingly, Senator Hollis seemed particularly concerned about the viability of private universities. He estimated that the war conscripted half of private universities' students, and without private donors, “it is going to be a very serious problem whether [private universities] . . . can be kept open at all.” *Id.*

36. *Id.*

37. 55 *CONG. REC.* 6729 (1917) (statement of Sen. Simmons).

prevention of cruelty to children or animals.”<sup>38</sup> As Senator Simmons requested, it limited the availability of the charitable deduction to 15 percent of an individual’s “taxable net income.”<sup>39</sup>

The charitable deduction available to individuals has since remained a part of the federal income tax, and the core of charitable deductions has gone through only minor changes in the intervening century.<sup>40</sup> Subsequent legislation has expanded the types of organizations that qualify to receive deductible contributions. In addition to corporations organized for the five purposes mentioned in the War Revenue Act of 1917, today, donations to states, their political subdivisions, and organizations that foster amateur sports competition qualify as deductible.<sup>41</sup>

Over time, Congress has raised the ceiling on deductibility while also creating several different tiers of ceilings. Today, an individual can deduct up to 60 percent of her “contribution base” (roughly her adjusted gross income),<sup>42</sup> provided the donation is in cash and made to a public charity.<sup>43</sup> Contributions of noncapital assets to public charities face a ceiling of 50 percent,<sup>44</sup> while contributions of some

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38. War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 300, 330.

39. *Id.*

40. Ellen P. Aprill, *Churches, Politics, and the Charitable Contribution Deduction*, 42 B.C. L. REV. 843, 849 (2001). “Minor changes” does not, of course, mean “no changes.” Plenty of exceptions, clarifications, and industry-specific provisions have been added; recently, a student preparing for finals discovered that some whaling captains can deduct up to \$10,000 a year that they spend on certain “subsistence bowhead whale hunting activities.” See I.R.C. § 170(n)(1)–(3) (2018). Notwithstanding these exceptions, clarifications, and virtually inexplicable provisions, though, the general contours of the charitable deduction roughly approximate those enacted in 1917.

41. I.R.C. § 170(c)(1), (2)(B). While the charitable deduction itself has changed little, the context surrounding it has changed radically. In its initial incarnation, there was no limitation on who could take a charitable deduction—anybody who paid taxes could deduct qualifying charitable contributions. In 1944, Congress introduced the standard deduction to the tax law. Allan J. Samansky, *Nonstandard Thoughts About the Standard Deduction*, 1991 UTAH L. REV. 531, 532 (1991). The standard deduction technically did not affect the deduction for charitable giving. Still, it reduced the likelihood that any given taxpayer would deduct her charitable contributions. In 1944, the standard deduction was 10 percent of a taxpayer’s adjusted gross income if her adjusted gross income was less than \$5000, or \$500 if it was \$5000 or more. Individual Income Tax Act of 1944, ch. 210, § 9(a)(1), 58 Stat. 231, 236. A taxpayer could elect to take the standard deduction but, if she did, it replaced most of her other deductions, including the deduction for charitable contributions. *Id.* § 9(a)(2), 58 Stat. at 236–37. The year of its enactment, 82 percent of individuals who filed a tax return elected the standard deduction and thus did not deduct their charitable contributions, if any. Samansky, *supra*, at 532–33.

42. I.R.C. § 170(b)(1)(H).

43. *Id.* § 170(b)(1)(A), (G)(i).

44. *Id.* § 170(b)(1)(A). Under current law, the 60 percent deduction for cash contributions made to public charities will drop back to 50 percent for taxable years starting after December 31, 2025. *Id.* § 170(b)(1)(G)(i).

capital gain assets—as well as donations made “for the use of” (rather than “to”) a public charity<sup>45</sup>—face a 30 percent ceiling.<sup>46</sup>

The complexity does not end there. While the charitable deduction regime has remained roughly the same throughout its existence, the rules governing charitable donees have changed in many ways. One significant change is that charitable donees have been bifurcated into two types of organizations: public charities and private foundations.<sup>47</sup> Private foundations share the same charitable purposes as public charities but have different funding models. Where public charities receive broad public support, private foundations receive their support from a relatively small number of donors.<sup>48</sup> A donor can only deduct donations to, or for the use of, private foundations up to 30 percent of her contribution base<sup>49</sup> and faces a 20 percent ceiling on her donations of capital gain property.<sup>50</sup>

Just like the mechanics of the charitable deduction have seen little change over the first century of the deduction’s life, today’s justifications for the charitable deduction mirror Senator Hollis’s original statements. The principal justification for a charitable deduction—to encourage charitable giving—“is to this day the major rationale for a deduction.”<sup>51</sup>

Although the deduction-as-incentive justification is historically rooted and feels both intuitive and compelling, it is not the only explanation offered. A secondary justification is that an income tax better meets the policy goal of horizontal equity when a taxpayer can deduct her charitable donations.<sup>52</sup> According to this explanation, an

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45. The Code defines a charitable contribution as “a contribution or gift to or for the use of” qualifying donees. *Id.* § 170(c). The 50 and 60 percent deduction limitations only apply to gifts made *to* a qualifying organization, though. *Id.* § 170(b)(1)(A), (G)(i). Thus, gifts made *for the use of* those organizations face the lower ceiling. While the Code does not define what constitutes *for the use of*, the Treasury regulations provide that a transfer of an income interest, whether in trust or not, is *for the use of* a charitable organization, while the transfer of a remainder interest is made *to* the organization. Treas. Reg. § 1.170A-8(a)(2) (1972).

46. I.R.C. § 170(b)(1)(B)(i), (C).

47. *See id.* § 509(a).

48. Nina J. Crimm, *Through a Post-September 11 Looking Glass: Assessing the Roles of Federal Tax Laws and Tax Policies Applicable to Global Philanthropy by Private Foundations and Their Donors*, 23 VA. TAX REV. 1, 62 (2003). For a more detailed discussion of private foundations, see *infra* Part III.

49. I.R.C. § 170(b)(1)(B).

50. *Id.* § 170(b)(1)(D)(i).

51. Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1396 (1988); *see also* David E. Pozen, *Remapping the Charitable Deduction*, 39 CONN. L. REV. 531, 552 (2006) (“In Congress, the courts, the media, and now academia, the deduction is widely viewed not as a means to reify the ideal tax base or reward praiseworthy donors, but as a tax expenditure used to promote charitable giving and thereby the ultimate well-being of society.”).

52. *See* C. Eugene Steuerle & Martin A. Sullivan, *Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations*, 12 AM. J. TAX POL’Y 399, 404–05 (1995). Horizontal

appropriate measurement of income would exclude charitable donations for two reasons: charitable transfers do not represent personal consumption, and charitable donors lose the ability to control the use of the donated amounts and can no longer personally benefit from them.<sup>53</sup>

These two explanations are not necessarily inconsistent. In fact, the measurement-of-income justification for the charitable deduction may “enhance[] the incentive argument for a deduction.”<sup>54</sup> Under either justification, though, the money must go toward something society has deemed worthy because it replaces spending that would otherwise fall to the government.<sup>55</sup> Merely giving up control over money cannot, by itself, be enough, or we would allow taxpayers to deduct gifts and other gratuitous transfers they make.<sup>56</sup>

### III. PRIVATE FOUNDATIONS

Individuals who donate to operating charities are not the only taxpayers who can take a charitable deduction. Broadly speaking, there are two categories of deduction-eligible charities: those operating public charities and those operating private foundations.<sup>57</sup> The logic of allowing a charitable deduction to taxpayers is

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equity holds that in a fair income tax, similarly situated taxpayers should pay about the same amount in taxes. Samuel D. Brunson, *Taxing Utopia*, 47 SETON HALL L. REV. 137, 185 (2016).

53. Steuerle & Sullivan, *supra* note 52, at 405.

54. *Id.* Neither justification fits perfectly with the current income tax. In 2016, only 25 percent of tax returns claimed a charitable deduction. Mitchell Franklin & Michael L. Morrow, *Taxpayers Just Want Tax-Deductible Fun; Congress Ends the Party*, 161 TAX NOTES 1341, 1342 (2018). In 2018, with the standard deduction nearly doubled, the Joint Committee on Taxation estimates that only about 12 percent of taxpayers will itemize, meaning that at most, 12 percent of taxpayers will be able to deduct their charitable contributions. Erica York & Alex Muresianu, *The Tax Cuts and Jobs Act Simplified the Tax Filing Process for Millions of Households*, 90 ST. TAX NOTES 965, 967 (2018). Those 88 percent of taxpayers who do not itemize will include the amount of their charitable contributions in their taxable income, meaning that two individuals who earn the same amount and do not itemize will pay the same amount in taxes, even if one donates a quarter of her income to charitable organizations while the other donates nothing. Moreover, in theory, those 88 percent of taxpayers do not have a tax incentive to make charitable contributions because they get no tax benefit from their contributions. *But see* Lilian V. Faulhaber, *The Hidden Limits of the Charitable Deduction: An Introduction to Hypersalience*, 92 B.U. L. REV. 1307, 1309–10 (2012) (arguing that taxpayers overestimate the likelihood that they will get the charitable deduction because they are acutely aware of the deduction’s existence but underaware of its limitations).

55. *See* Steuerle & Sullivan, *supra* note 52, at 403–04.

56. While the recipient of a gift does not have to include the gift in her gross income, I.R.C. § 102(a), the giver of a gift cannot deduct the gift if it is not made to a qualifying tax-exempt organization, *id.* § 170(a)(1).

57. Tanya D. Marsh, *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX REV. 137, 139 (2002).

significantly more tenuous when it comes to private foundations rather than to public charities.

While both public charities and private foundations must be organized and operated for certain exempt purposes,<sup>58</sup> there are a number of differences between the two. Perhaps the most salient difference is that a private foundation is generally funded by a small number of individuals, while a public charity receives the bulk of its revenue from the general public.<sup>59</sup> Private foundations are generally controlled by the person or persons who contribute to them.<sup>60</sup> In contrast to public charities, which engage in active charitable endeavors, private foundations generally provide grants rather than charitable services.<sup>61</sup>

In the earliest decades of the federal income tax, the tax law treated public charities and private foundations the same.<sup>62</sup> By 1950, the government had become concerned about abusive foundation behavior.<sup>63</sup> The government saw wealthy individuals donating some of their ownership of active businesses to foundations—while still effectively controlling them—to avoid estate and gift taxes.<sup>64</sup> To prevent these abuses, Congress imposed some limitations on tax-exempt organizations in general but exempted public charities from those requirements.<sup>65</sup> With that, the tax law began to treat public charities differently from private foundations.<sup>66</sup>

In 1964, Congress continued to rework the precise nature of these tax rules as it dealt with its concerns. Congress was unhappy that private foundations provided donors with an immediate deduction while “frequently[,] contributions to foundations do not find their way into operating philanthropic endeavors for extended periods of time.”<sup>67</sup> The subsequent year, a U.S. Department of the Treasury report explained that about a quarter of private foundations had distributed less than their net income for charitable purposes.<sup>68</sup>

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58. I.R.C. § 509(a) (2018).

59. Treas. Reg. § 1.509(a)-3(a)(1) (as amended in 2011) (“Section 509(a)(2) excludes certain types of broadly, publicly supported organizations from private foundation status.”).

60. Garry W. Jenkins, *Soft Power, Strategic Security, and International Philanthropy*, 85 N.C. L. REV. 773, 788 n.47 (2007).

61. *See id.*

62. Marsh, *supra* note 57, at 148–49.

63. *See* Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52, 53 (2000).

64. *Id.*

65. *Id.* at 53–54.

66. Marsh, *supra* note 57, at 149 (“The beginning of the private/public distinction as a proxy for the pivotal variable, level of donor control, originated in this 1950 legislation.”).

67. S. REP. NO. 88-830, at 60 (1964).

68. STAFF OF S. COMM. ON FIN., 89TH CONG., TREASURY DEP’T REP. ON PRIVATE FOUNDATIONS 26 (Comm. Print 1965).

To ensure that private foundations distributed their income to philanthropic organizations, the Treasury recommended that each private foundation be required to distribute either its income or an amount equivalent to a reasonable return on its assets (which the Treasury estimated to be between 3 and 3.5 percent).<sup>69</sup> In 1969, Congress adopted the Treasury's second suggestion but increased the required distribution to 6 percent of the private foundation's net assets.<sup>70</sup>

In the ensuing fifty years, this specific rule for private foundations has expanded into several rules that constrain private foundations and their donors. The first is that donors have a lower ceiling on deductible donations. Where donors to public charities can deduct donations of up to 60 percent of their contribution base,<sup>71</sup> donors to private foundations face a much lower ceiling. On most donations, donors to a private foundation can only deduct 30 percent of their contribution base.<sup>72</sup> Further, donors to a private foundation can only deduct amounts up to 20 percent of their contribution base on any capital gain property they contribute.<sup>73</sup>

Other limitations on private foundations are largely enforced by a series of excise taxes. For example, Congress was concerned about private foundations engaging in self-dealing transactions,<sup>74</sup> so it imposed an excise tax on foundations of 10 percent on the amount involved in self-dealing.<sup>75</sup> To prevent foundations from sheltering active business income, they also face a 10 percent excise tax on any excess business holdings.<sup>76</sup> In an attempt to discourage private foundations from making excessively risky investments, they face a 10 percent excise tax on the amount of such investments.<sup>77</sup> Also, if a private foundation makes a "taxable expenditure" (which is

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69. *Id.* at 28–29.

70. Troyer, *supra* note 63, at 57.

71. *See supra* notes 42–46 and accompanying text.

72. I.R.C. § 170(b)(1)(B)(i) (2018).

73. *Id.* § 170(b)(1)(D)(i).

74. Troyer, *supra* note 63, at 57.

75. I.R.C. § 4941(a)(1). The tax law imposes an additional 5 percent excise tax on foundation managers who are aware of the self-dealing. *Id.* § 4941(a)(2).

76. Technically, this excise tax on risky investments applies to investments which "jeopardize the carrying out of any of [the private foundation's] exempt purposes." *Id.* § 4943(a). An impermissible investment is one where the foundation managers have exercised insufficient care in providing for the long-term and the short-term needs of the foundation. Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973). To calculate whether a private foundation has excess business holdings, it must add the stock it owns to the stock owned by its disqualified persons. If they collectively own more than 20 percent of a corporation—or 35 percent if the corporation is controlled by an unrelated person—the private foundation has taxable excess business holdings. I.R.C. § 4943(c)(2)(A)–(B).

77. I.R.C. § 4944(a)(1). As with the excise tax on self-dealing, this one also comes with an excise tax on management, this time of an additional 10 percent. *Id.* § 4944(a)(2).

essentially any expenditure for a noncharitable purpose),<sup>78</sup> it owes an excise tax of 20 percent of the amount of the expenditure.<sup>79</sup>

The tax law still requires private foundations to make minimum distributions, though the amount has fallen from 6 percent in 1969 to 5 percent today.<sup>80</sup> As with the other rules, the minimum distribution is enforced through an excise tax. To the extent the private foundation distributes less than the required 5 percent, it must pay a 30 percent excise tax on the underdistributed amount.<sup>81</sup>

Finally, private foundations must pay a 1.39 percent tax on their net investment income.<sup>82</sup> On its face, this tax does not intend to encourage particular behavior; rather, Congress imposed it because government benefits are available to everyone and “the costs should be borne, at least to some extent, by all of those able to pay.”<sup>83</sup> Congress also characterized this tax as a “user fee,” paid because of the “vigorous and extensive administration . . . needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes.”<sup>84</sup>

Although this last tax is structured to raise revenue rather than encourage or discourage particular behavior, it had a behavioral component. Prior to December 2019, the default excise rate was 2 percent. If a private foundation distributed an amount equal to its average distribution percentage from the prior five years plus 1 percent, and it did not owe an excise tax on an undistributed amount, this tax fell from 2 percent to 1 percent.<sup>85</sup> In other words, until Congress changed the law, a private foundation could reduce its putative user fee by making sufficient distributions.

With all of the additional regulation and limitations on top of the normal rules that apply to public charities, it is worth asking why private foundations even exist. Why would someone want to organize a private foundation, subject to the limitations and taxes they face, when instead they could just directly make charitable grants?

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78. *See id.* § 4945(d).

79. *Id.* § 4945(a)(1). Again, management may be subject to a 5 percent excise tax in addition to the amount paid by the private foundation. *Id.* § 4945(a)(2).

80. *Id.* § 4942(d)–(e)(1).

81. *Id.* § 4942(a).

82. *Id.* § 4940(a).

83. H.R. REP. NO. 91-413, pt. 1, at 19 (1969). Interestingly, though, there is no equivalent tax on the net investment income of public charities, in spite of the fact that they, too, enjoy the benefits of government and many could afford to pay at least a portion of the costs. *See, e.g.*, Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L.J. 299, 327 (1976).

84. H.R. REP. NO. 91-413, at 19. It is worth noting that, although Congress justified this tax as a way to fund administration related to private foundations, it has not, in fact, been earmarked or used to pay for that administration. Trevor Findley, Comment, *Tax Treatment of Private Charitable Foundations: A Call to Simplify the Excise Tax*, 49 WILLAMETTE L. REV. 477, 490 (2013).

85. *See* I.R.C. § 4940(a), (e)(1)–(4) (repealed 2019).

One reason is for control. “Individuals can retain nearly unfettered control over the management and investment of assets contributed to their foundations.”<sup>86</sup> That control continues throughout a donor’s lifetime and may continue, at least to some extent, even after she dies.<sup>87</sup> A private foundation also allows a wealthy donor to inculcate charitable impulses in her descendants, as her children and grandchildren join her in choosing how to disperse charitable funds.<sup>88</sup> It also presents an opportunity for her to provide jobs for her descendants (and, effectively, to transfer some amount of wealth to them outside of the reaches of transfer taxes).<sup>89</sup>

Along with control, a private foundation can insulate wealthy individuals and families from the pressures of dealing directly with requests of grant-seeking organizations. With one entity receiving requests for grants and a board of directors determining whether to fund those grants, the process of making donations is both more objective and more removed from wealthy donors.<sup>90</sup>

Private foundations also provide donors with tax benefits. As discussed above, those benefits are more constrained than the benefits of giving to public charities in some ways—donors face a lower limitation on the amount they can deduct.<sup>91</sup> However, in some cases, private foundations provide a tax benefit to donors: they permit donors to accelerate their deductions. Of course, a donor to a private foundation has to part with her money to get the benefit of the deduction.<sup>92</sup> But she does not have to immediately determine what charitable organization will ultimately benefit from that deduction.

Charitable contributions to the foundation are deductible for income tax purposes in the year of the contribution, although actual distributions from the foundation to other charitable organizations may be deferred over time. Therefore, an upfront income tax charitable deduction is available, notwithstanding that the contributed funds are simply transferred to the donor’s private foundation, remain subject to the continuing control of the donor, and may be used to make distributions over a long

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86. Marsh, *supra* note 57, at 166.

87. *Id.*

88. *Id.*

89. See, e.g., Matthew F. Jones, Comment, *The Other Family Tree: Leaving Your Legacy in a Private Foundation*, 63 ALB. L. REV. 567, 585–86 (1999) (“The children of the rich grantor may be required to serve as trustees or in other capacities in order to earn money from the private foundation in exchange for the services they provide for it.”).

90. Michelle Coleman-Johnson, *Creating a Family Foundation*, 17 PROB. & PROP., Sept./Oct. 2003, at 10, 15.

91. See *supra* notes 71–73 and accompanying text.

92. See Treas. Reg. § 1.170A-1(a) (as amended in 2019) (“Any charitable contribution . . . actually paid during the taxable year is allowable as a deduction in computing taxable income.”).

period of time well beyond the year in which the contribution is first made to the foundation.<sup>93</sup>

In fact, without the private foundation minimum distribution requirement, donors could get a current deduction for money that never goes to active charity, stymying the goals underlying the charitable deduction.

#### IV. DONOR-ADVISED FUNDS

In many ways, donor-advised funds are the younger siblings of private foundations. Donor-advised funds provide donors with a similar ability to accelerate their charitable deductions while exercising some degree of control over the eventual charitable use of their funds.<sup>94</sup> Because of the administrative complexity of running a private foundation, though, it only makes sense for certain relatively wealthy individuals who intend to donate substantial amounts through the foundation.<sup>95</sup>

Although they are the younger siblings of private foundations, donor-advised funds are beginning to supplant their older siblings. “[D]onor-advised funds are widely replacing private foundations because they are less expensive to organize and administer; require fewer disclosures; provide more giving flexibility; and offer higher tax deductions. The taxpayer receives a tax deduction in the year the assets are transferred to the donor-advised fund.”<sup>96</sup> These advantages make donor-advised funds an attractive vehicle for individuals who want current tax deductions but also want to delay determining the ultimate recipient of their charitable largesse.<sup>97</sup>

Donor-advised funds—“[o]ften referred to as the ‘poor man’s’ private foundation”—are public charities that, in many ways, function like private foundations.<sup>98</sup> In essence, a donor to a donor-advised fund makes a charitable contribution to a tax-exempt

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93. Richard L. Fox & Jonathan G. Blattmachr, *Plan Now to Avoid the Private Foundation Excise Tax Rules*, 29 TAX’N EXEMPTS, May/June 2018, at 28, 30.

94. Roger Colinvaux, *Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy*, 92 WASH. L. REV. 39, 71 (2017) (noting that donor-advised funds provide “a current deduction but delayed decision”).

95. Fox & Blattmachr, *supra* note 93, at 30–31.

96. Carrie Brandon Elliot, *Taxation of Cross-Border Nonprofit Activity*, TAX NOTES INT’L, Nov. 26, 2018, at 867, 868.

97. Professor John Brooks contends that accelerating a charitable deduction does not provide any substantive benefit to taxpayers because taxpayers could instead purchase an investment asset, not pay taxes on its appreciation, and donate it in the future to get a higher deduction. John R. Brooks, *The Missing Tax Benefit of Donor-Advised Funds*, 150 TAX NOTES 1013, 1016 (2016). Under certain conditions, that is certainly true. Still, at the very least, individuals perceive an advantage to accelerating their deductions and can use donor-advised funds to do so.

98. Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 32 (2011).

sponsoring organization.<sup>99</sup> That sponsoring organization creates an account in the donor's name and allocates each donor's donations into the appropriate segregated account.<sup>100</sup> While donors no longer have any ownership interest in their donations, they retain the right to advise the sponsoring organization on how to distribute their donations.<sup>101</sup> Because donors have given up ownership of their donations, the sponsoring organization has the legal right to ignore their recommendations.<sup>102</sup> Still, sponsoring organizations generally distribute funds in accordance with donors' wishes<sup>103</sup>—otherwise, donors are likely to donate their money elsewhere.

Today's donor-advised funds can trace their roots to the 1930s, when the New York Community Trust established the first such fund.<sup>104</sup> For the first several decades of their existence, donor-advised funds were generally sponsored by community foundations and were relatively unknown.<sup>105</sup> That changed with the birth of the commercial sponsor.<sup>106</sup> The first commercial sponsor, the Fidelity Charitable Gift Fund ("Fidelity Charitable"), was launched in 1991, and since then, a number of other commercial sponsors have organized donor-advised funds.<sup>107</sup>

Many of the commercial sponsors of donor-advised funds are brokerage houses.<sup>108</sup> After donors donate money, but before they request that the fund disperse that money to other charities, the sponsors invest the funds in mutual funds that they manage.<sup>109</sup> Just like mutual funds have democratized diversified investments to some extent,<sup>110</sup> in theory, donor-advised funds provide a way for middle-income, if not poor, donors to reap similar advantages to those

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99. Roger Colinvaux, *Defending Place-Based Philanthropy by Defining the Community Foundation*, 2018 BYU L. REV. 1, 22 (2018).

100. *Id.*

101. *Id.*

102. *See, e.g.*, *Styles v. Friends of Fiji*, No. 51642, 2011 WL 488951, at \*1 (Nev. Feb. 8, 2011) ("[T]he district court properly determined in accordance with the agreement's express terms that Styles gave up any interest in the money when he made the unrestricted gift to [Friends of Fiji], allowing [Friends of Fiji] the discretion to reject any of his recommendations for the donation's use.").

103. Colinvaux, *supra* note 99, at 22.

104. John F. Coverdale, *Legislating in the Dark: How Congress Regulates Tax-Exempt Organizations in Ignorance*, 44 U. RICH. L. REV. 809, 814 (2010).

105. *Id.*

106. Colinvaux, *supra* note 99, at 22.

107. *Id.* at 22–23.

108. Coverdale, *supra* note 104, at 814.

109. *See id.* at 813–14. Sponsoring donor-advised funds is one way these sponsoring organizations can attract additional money into their mutual funds. *Id.* at 814.

110. *See* Samuel D. Brunson, *The Taxation of RICs: Replicating Portfolio Investment or Eliminating Double Taxation?*, 20 STAN. J.L. BUS. & FIN. 222, 241 (2015) ("RICs were designed as a way for unsophisticated, low-to-middle-income investors to get the benefits of diversification and professional portfolio management.").

foundations provide to the wealthy.<sup>111</sup> Fidelity Charitable, a donor-advised fund that displaced the United Way as the top charitable fundraiser in 2016,<sup>112</sup> allows donors to open an account with a minimum contribution of \$5000 and has no minimum balance requirement.<sup>113</sup> However, in practice it appears that the average donor to a donor-advised fund is relatively wealthy. James Andreoni, an economist at UC San Diego, estimated, based on contributions to and distributions from donor-advised fund accounts, that the average donor to donor-advised funds had income between about \$1.4 million and \$2.2 million.<sup>114</sup>

While donor-advised funds look like private foundations in many ways, there are certain salient differences—some advantageous to donors and some disadvantageous. Disadvantages include, for instance, that a donor to a donor-advised fund gives up some level of control in comparison to a private foundation. The donor to a private foundation exercises actual control over the foundation, directing both the timing and recipients of its charitable giving.<sup>115</sup> Donor-advised funds listen to donors' recommendations and are likely to follow them, but donors to donor-advised funds still risk losing control over their donations.<sup>116</sup> Likewise, because donor-advised funds are professionally managed, wealthy donors cannot use them to employ family members or otherwise transfer wealth to subsequent generations.<sup>117</sup>

Those disadvantages are, in many cases, outweighed by the advantages of donor-advised funds. For instance, commercial donor-

111. See *supra* note 98 and accompanying text.

112. Drew Lindsay et al., *Fidelity Charitable Pushes United Way Out of Top Place in Ranking of the 400 U.S. Charities That Raise the Most*, CHRON. PHILANTHROPY (Oct. 27, 2016), <https://www.philanthropy.com/article/Fidelity-Charitable-Knocks/238167> [<https://perma.cc/HM7Q-EB8R>].

113. *What It Costs*, FIDELITY CHARITABLE, <https://www.fidelitycharitable.org/giving-account/what-it-costs.shtml> (last visited May 1, 2020) [<https://perma.cc/EDA9-T4HP>].

114. James Andreoni, *The Benefits and Costs of Donor Advised Funds* 7 (Nat'l Bureau of Econ. Research, Working Paper No. 23872, 2017), <https://www.nber.org/papers/w23872.pdf> [<https://perma.cc/K44K-8QPC>].

115. See Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1195 (2001) (“[A]n attribute associated with private foundations is control by donors and individuals loyal to them.”).

116. See *supra* notes 102–03 and accompanying text.

117. Cf. *supra* note 89 and accompanying text. While donors to donor-advised funds cannot use these funds to employ or transfer assets to their descendants, donors can use donor-advised funds to inculcate philanthropic values in their descendants. When the donor to a donor-advised fund dies, she can name succeeding advisors who will step into her shoes to make grant recommendations. See, e.g., *If I Establish a Donor-Advised Fund, What Happens After My Death?*, COMMUNITY FOUND. OF MONROE COUNTY, <https://www.cfmonroe.org/faq/establish-donor-advised-fund-happens-death/> (last visited May 1, 2020) [<https://perma.cc/9EVT-35E5>].

advised funds have professional management<sup>118</sup> and, as such, do not impose an administrative burden on donors the way that private foundations do, and they generally cost less to operate.<sup>119</sup>

Beyond the ability to minimize administrative burden and cost, donor-advised funds present a significant tax advantage over private foundations: for tax purposes, donations to donor-advised funds are donations to public charities.<sup>120</sup> Why do the donations qualify as donations to public charities? Because each donor-advised fund is effectively a segregated fund in a sponsoring organization, and the sponsoring organization qualifies as a public charity.<sup>121</sup> The sponsoring organization, in turn, must be organized for a statutorily exempt purpose and cannot be a private foundation.<sup>122</sup>

A sponsoring organization should have no problem avoiding private foundation status. It merely needs to ensure that more than one-third of its support each year comes from people other than “disqualified persons”<sup>123</sup> and that not more than one-third of its income consists of unrelated business taxable income and investment income.<sup>124</sup> For these purposes, a “disqualified person” is generally a person who contributes the greater of \$5000 or 2 percent of the contributions received by a tax-exempt organization.<sup>125</sup> In 2012, the seven largest sponsoring organizations managed over 100,000 individual funds.<sup>126</sup> Because the sponsoring organization, not the individual fund, is the recipient of the charitable dollars, the sponsoring organization is unlikely to have any individual who provides more than one-third of its income, and thus should qualify as a public charity.<sup>127</sup> And in 2015, \$4.6 billion of Fidelity

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118. Colinvaux, *supra* note 94, at 66 n.113.

119. Raymond G. Russolillo, *Planning Options for the Philanthropic Client*, 85 PRAC. TAX STRATEGIES 204, 209 (2010).

120. Colinvaux, *supra* note 94, at 67 (noting that donor-advised funds “indubitably are recognized as 501(c)(3) public charities”).

121. David Wheeler Newman & Jacey L. Hayes, *An Updated Guide to Donor-Advised Funds*, 20 TAX’N EXEMPTS, Mar./Apr. 2009, at 28, 28 (“The donor contributes property to a separate fund maintained by a public charity that is referred to as the sponsoring organization.”).

122. I.R.C. § 4966(d)(1)(B), (2) (2018).

123. *Id.* § 509(a)(2)(A).

124. *Id.* § 509(a)(2)(B). The sponsoring organizations of donor-advised funds (such as Fidelity Charitable) technically qualify as “public foundations.” Marsh, *supra* note 57, at 142.

125. I.R.C. §§ 507(d)(2)(A), 509(a)(2), 4946(a)(1).

126. Paul Arnsberger, *Donor-Advised Funds: An Overview Using IRS Data*, in THE RISE OF DONOR ADVISED FUNDS: SHOULD CONGRESS RESPOND? 61, 63 (2015), <https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1017&context=philanthropy-forum> [<https://perma.cc/U9XU-8AAR>].

127. See Terry W. Knoepfle, *The Pension Protection Act of 2006: A Misguided Attack on Donor-Advised Funds and Supporting Organizations*, 9 FLA. TAX REV. 221, 224 (2009) (“Supporting organizations are public charities that fulfill their exempt purposes by supporting one or more other exempt organizations.”).

Charitable's \$5.4 billion in revenue came from fresh contributions,<sup>128</sup> meaning less than one-third of its income would have been disqualifying.

Because donor-advised funds are parts of public charities rather than private foundations, they avoid many of the limitations that private foundations face. Donors, for example, get the higher deductibility ceilings, and the donor-advised funds do not face the minimum distribution requirements or the various excise taxes faced by private foundations.<sup>129</sup> In fact, the tax law only imposes a single regulatory limitation on donor-advised funds that it does not apply to public charities in general. A donor-advised fund must pay a 20 percent tax on any taxable distribution it makes.<sup>130</sup> A taxable distribution is any distribution a donor-advised fund makes to individuals (or to any other person) if the purpose of the distribution is a nonexempt purpose or if the donor-advised fund does not exercise responsibility over its expenditure.<sup>131</sup>

## V. PROBLEMS WITH DONOR-ADVISED FUNDS

While donor-advised funds have existed in some form since the 1930s,<sup>132</sup> Congress did not explicitly mention them in the tax law until 2006.<sup>133</sup> Although a significant percentage of the Tax Reform Act of 1969 dealt with tax-exempt organizations, creating the private foundation regime,<sup>134</sup> it allowed donor-advised funds to slip through the cracks. As a result, donor-advised funds have enjoyed the more generous treatment available to public charities while acting in many ways like private foundations.<sup>135</sup> For this reason, donor-advised

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128. Felix Salmon, *The Disrupter: How Fidelity and Its Donor-Advised Fund Are Shaking up Charitable Giving for the Better*, SLATE (May 11, 2018, 9:00 AM), <https://slate.com/business/2018/05/fidelitys-donor-advised-fund-is-shaking-up-charitable-giving.html> [<https://perma.cc/F8CD-JDSW>].

129. Marsh, *supra* note 57, at 169.

130. I.R.C. § 4966(a)(1). Fund managers owe an additional 5 percent tax on taxable distributions. *Id.* § 4966(a)(2).

131. *Id.* § 4966(c)(1). Congress enacted this tax on certain distributions by donor-advised funds in 2006. James A. Borrasso Jr., *Opening the Floodgates: Providing Liquidity to the Charitable Marketplace Through Changes to Donor-Advised Funds*, 2018 U. ILL. L. REV. 1533, 1540 (2018). In that legislation, which first mentioned and defined *donor-advised fund* for tax purposes, Congress intended to curtail potential abuses of donor-advised funds. *Id.*

132. See *supra* note 104 and accompanying text.

133. Michael J. Hussey, *Avoiding Misuse of Donor Advised Funds*, 58 CLEV. ST. L. REV. 59, 64 (2010) ("For the first time [in 2006], donor advised funds were defined in the Internal Revenue Code.").

134. William H. Byrnes, IV, *The Private Foundation's Topsy Turvy Road in the American Political Process*, 4 HOUS. BUS. & TAX L.J. 496, 580 (2004) ("Approximately one-third of the 1969 Tax Reform Act dealt with tax exempt organizations.").

135. The treatment of private foundation-like donor-advised funds as public charities may not have been an accidental oversight by Congress. Norman Sugarman, an expert on the tax law and former employee at the IRS, helped draft

funds “have become an end run around the private foundation rules.”<sup>136</sup>

Allowing donor-advised funds to act like private foundations while giving them the benefits of public charities creates at least two significant problems. First, it allows donors to accelerate their charitable deduction while allowing their donated money to sit in the fund—potentially indefinitely—without being used in actual charitable endeavors. Second, it provides a means by which tax-exempt organizations can qualify as public charities in spite of lacking broad public support.

#### A. *Donor-Advised Funds May Supplant Private Foundations*

With their tax advantages and smaller administrative burdens, donor-advised funds are beginning to supplant private foundations.<sup>137</sup> Donor-advised funds provide almost all of the benefits of private foundations without any of the limitations specific to private foundations.<sup>138</sup> And, while most donors to donor-advised funds appear to be wealthy, donor-advised funds, at least in theory, democratize the world of accelerated charitable deductions and delayed giving, providing an affordable and easy vehicle for the middle class to employ.

Is this democratization good? Perhaps. Professor Daniel Hemel argues that donor-advised funds do two important things.<sup>139</sup> First, they allow donors to transfer appreciated assets to small, unsophisticated charities.<sup>140</sup> Second, they “facilitate charitable giving over the life cycle [of the donor].”<sup>141</sup> This facilitation, Professor Hemel explains, allows individuals to claim charitable deductions in their highest earning years and then to actually practice charity when they are older and have more time but less income.<sup>142</sup>

Both of these functions may be beneficial to society, at least if donors to donor-advised funds are making contributions that they

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portions of the 1969 Act on behalf of the Council of Jewish Federations and other philanthropic organizations. Lila Corwin Berman, *How Americans Give: The Financialization of American Jewish Philanthropy*, 122 AM. HIST. REV. 1459, 1476 (2017). Sugarman helped ensure that donor-advised funds could operate in a way that “braided together public privileges and private interests, all while operating in the legal lacunae of the 1969 tax law’s classificatory apparatus.” *Id.* at 1477.

136. Lee A. Sheppard, *Disciplining Donor-Advised Funds*, 164 TAX NOTES FED., Aug. 5, 2019, at 795, 799.

137. Elliot, *supra* note 96, at 868.

138. *See id.*

139. Daniel Hemel, *Life, Death, and Donor Advised Funds*, WHATEVER SOURCE DERIVED (Aug. 15, 2018), <https://medium.com/whatever-source-derived/life-death-and-donor-advised-funds-180c7644c833> [<https://perma.cc/9D6U-8L4T>].

140. *Id.*

141. *Id.*

142. *Id.*

otherwise would not have made.<sup>143</sup> It is currently an open question, though, whether donor-advised funds increase charitable giving or whether they merely receive charitable dollars that would have otherwise been donated to a private foundation or to a public charity.<sup>144</sup> If they increase the charitable dollars available, they may serve a valuable purpose. But if they do not increase charitable dollars available, donor-advised funds may be harmful because they cannibalize charitable giving that otherwise would have gone to private foundations and public charities. This type of cannibalization imposes social cost: “The longer that money sits unused in a [donor-advised fund], the longer that urgent needs of working charities and those they serve go unmet.”<sup>145</sup> In other words, with fewer current donations, public charities are unable to provide the same societal benefits they could provide if they receive donations directly.

The idea that deferring charity creates societal harm is not an uncontested view. There is an academic discourse built around the question of whether “current generations owe anything at all to future generations.”<sup>146</sup> There has been no universal conclusion,<sup>147</sup> but people broadly seem to believe that “future generations should count, and most likely count equally to those currently alive.”<sup>148</sup> If we should take future generations into account in our current decision-making—and especially if they count equally to current generations—the idea of preferring current charitable distributions may lose some of its power. That is especially the case if the private foundation or donor-advised fund that holds charitable dollars instead of distributing them earns a high enough return on those assets. Provided that the discount rate applied to the future charitable donation is equal to the market rate of return a foundation or donor-advised fund can earn on the money, society should be indifferent as to whether charitable expenditures occur today or in the future.<sup>149</sup>

However, even if society arrives at the correct discount rate, there are compelling arguments for why current charitable expenditures are preferable to future charitable expenditures. Professor Brian Galle argues that—discount rate and return notwithstanding—

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143. See Colinvaux, *supra* note 94, at 51.

144. *Id.* (“Are [donor-advised funds] attracting money that would have been contributed anyway, but to a private foundation or to another public charity? Or are [donor-advised funds] attracting new charitable contributions that otherwise would have been privately consumed?”).

145. Roger Colinvaux, *Fixing Philanthropy: A Vision for Charitable Giving and Reform*, 162 TAX NOTES 1007, 1011 (2019).

146. Neil H. Buchanan, *What Do We Owe Future Generations?*, 77 GEO. WASH. L. REV. 1237, 1250 (2009).

147. *Id.*

148. David A. Weisbach & Cass R. Sunstein, *Introduction to Symposium on Intergenerational Equity and Discounting*, 74 U. CHI. L. REV. 1, 1 (2007).

149. See Dexter Samida & David A. Weisbach, *Paretian Intergenerational Discounting*, 74 U. CHI. L. REV. 145, 154–55 (2007).

current charitable spending can have long-term benefits that may not accrue with deferred spending.<sup>150</sup> He argues that future spending may have diminishing marginal returns, because either (1) a wealthier future generation will have more assets to solve problems, or (2) as the charitable sector increases it will solve the more pressing problems, so future charitable money will be relegated to solving less important problems.<sup>151</sup> He also argues that spreading spending to the future increases agency cost and decreases the information available to donors and to the government.<sup>152</sup>

Beyond these specific arguments about charitable giving, Professor Neil Buchanan makes two tentative assertions about intergenerational justice. First, because future generations are likely to be richer than the current generation, the current generation should worry less about saving for future generations and more about caring for itself.<sup>153</sup> Second, even if the current generation acts entirely selfishly, “we are still likely to adopt policies that end up making future generations better off, notwithstanding whether or not we care to do so.”<sup>154</sup>

While commentators make a convincing argument that, social discount rate notwithstanding, current charitable spending is more beneficial than future spending, the argument is not overwhelming. It is tentative enough that it does not demand the complete elimination of benefits for future giving. And, in fact, that seems to be the conclusion Congress came to when it designed rules for private foundations. It did not eliminate or delay charitable deductions to private foundations. Instead, because private foundations delay the active use of charitable money, they face significant regulation and control in the form of excise taxes and limitations on the activities in which they can participate.<sup>155</sup> Donor-advised funds manage to skirt both providing current active charity *and* the regulatory framework that Congress and the Internal Revenue Service (“IRS”) have built around private foundations.

Even if donor-advised funds increase charitable giving, merely being beneficial to society is not a compelling reason for having roughly the same level of oversight as public charities and receiving the same deductibility of donations as donors to public charities. After all, the justification for the deductibility of charitable

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150. Brian Galle, *Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy*, 93 WASH. U. L. REV. 1143, 1159 (2016). For example, he says, spending on hospice care may not have significant future benefit itself, but hospice care may lead to new methods of providing hospice care that will benefit future generations. *Id.* at 1159–60.

151. *Id.* at 1160.

152. *Id.* at 1162–63.

153. Buchanan, *supra* note 146, at 1287.

154. *Id.*

155. *See supra* notes 67–85 and accompanying text.

contributions is primarily to encourage the donation of money that the charity can use to pursue charitable purposes.<sup>156</sup>

In fact, in the early twentieth century, charitable foundations largely eschewed the development of endowments. In the 1910s, the Federation for the Support of Jewish Philanthropic Societies of New York City (“Federation”) provided in its bylaws that it could not accept legacies requiring it to hold the principal in trust and to limit its charitable distributions to income from the corpus.<sup>157</sup> To the extent it received a legacy, it had to distribute that legacy within three years.<sup>158</sup> In the 1920s, Catholic Charities chose to follow the Federation’s lead, writing its bylaws to similarly prohibit it from saving revenue in an endowment.<sup>159</sup> A century later, this distrust of charitable endowments has largely, though not entirely,<sup>160</sup> melted away. Money donated to donor-advised funds cannot be used immediately to pursue charitable purposes; those purposes must wait until the donor-advised fund distributes money to a charity.

And donor-advised funds *do* distribute money to charity. In 2017, the National Philanthropic Trust reported that donor-advised funds made grants equal to 22.1 percent of their assets.<sup>161</sup> But this payout rate is from overall funds, which masks differences between different donor-advised funds. Some funds pay out all of their assets annually while others hold assets indefinitely.<sup>162</sup> In general, the median—rather than the average—payout rate provides a better snapshot of the percentage payout that donor-advised funds make because outliers can significantly affect the average.<sup>163</sup>

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156. *See supra* notes 28, 37–38 and accompanying text.

157. Berman, *supra* note 135, at 1467.

158. *Id.*

159. *Id.* at 1468.

160. *See infra* notes 225–27 and accompanying text.

161. NAT’L PHILANTHROPIC TR., 2018 DONOR-ADVISED FUND REPORT 18 (2018), <https://www.nptrust.org/wp-content/uploads/2018/11/2018-DAF-Report.pdf> [<https://perma.cc/X4PS-VK22>]. The National Philanthropic Trust calculates the payout amount based on the amount of assets held on the first day of the year. Alan M. Cantor, *A Closer Look at a Donor-Advised Fund’s Questionable Payout Numbers*, INSIDE PHILANTHROPY (July 20, 2015), <https://www.insidephilanthropy.com/home/2015/7/20/a-closer-look-at-a-donor-advised-funds-questionable-payout-n.html> [<https://perma.cc/WQV4-T8N2>]. While this replicates the way private foundations calculate their payout rate, it arguably overstates the payout rate of donor-advised funds, which get additional donations over the course of the year. *See id.* And Fidelity Charitable began using a five-year rolling average of its assets to calculate its payout rate. Given that contributions to donor-advised funds are increasing almost exponentially, using the rolling average will definitely inflate the reported payout rate. *Id.*

162. *See infra* notes 169–73 and accompanying text.

163. Pamela Foohey et al., *Life in the Sweatbox*, 94 NOTRE DAME L. REV. 219, 235 n.91 (2018).

In 2012, the median donor-advised fund paid out just over 7 percent of its assets.<sup>164</sup> More than one-quarter of the sponsoring organizations reported payouts of less than 1 percent of their assets, and almost 22 percent made no distributions.<sup>165</sup> And even these numbers may overstate the amount of money that donor-advised funds gave to charity because the distributions from sponsoring organizations include not only money paid to public charities but also money paid to other donor-advised funds.<sup>166</sup>

Without the Internal Revenue Code (the “Code”) or the IRS imposing any minimum payout requirement on donor-advised funds, it is within each sponsoring organization’s discretion how much, if any, its minimum payout will be.<sup>167</sup> Commercial sponsoring organizations have little incentive to encourage donors to recommend distributions. Sponsoring organizations charge administrative and investment management fees to the funds.<sup>168</sup> Commercial sponsors of donor-advised funds also charge a fee based on the value of assets under management.<sup>169</sup> The more money donors leave undistributed in their donor-advised fund, the higher the fees a sponsoring organization will earn.

At the same time, sponsoring organizations face at least some pressure to make charitable distributions. Fidelity Charitable illustrates one way these conflicting incentives play out. Its policy guidelines provide that, while it has historically made grants of about 20 percent of its assets annually, it must make minimum grants of 5 percent of its assets.<sup>170</sup> In addition, Fidelity Charitable requires each donor to recommend grants at least once every four years.<sup>171</sup> If a fund does not distribute any grants for four years, Fidelity Charitable will make a grant to an approved charity from the fund in question.<sup>172</sup> After five years, Fidelity Charitable will consider the fund abandoned and will transfer all of its assets to an approved

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164. Arnsberger, *supra* note 126, at 64. Arnsberger calculated a donor-advised fund’s payout rate by dividing its grants for the year by the sum of its grants for the year and its assets at the close of the year. *Id.*

165. *Id.*

166. Ray Madoff, *Three Simple Steps to Protect Charities and American Taxpayers from the Rise of Donor-Advised Funds*, NONPROFIT Q. (July 25, 2018), <https://nonprofitquarterly.org/2018/07/25/three-simple-steps-to-protect-charities-and-american-taxpayers-from-the-rise-of-donor-advised-funds/> [https://perma.cc/3RBY-4ZF7].

167. *See supra* note 129 and accompanying text.

168. Mary C. Hester, *Donor-Advised Funds: When Are They the Best Choice for Charitably Minded Clients?*, 108 J. TAX’N 330, 344 (2008).

169. *Id.*

170. FID. CHARITABLE, FIDELITY CHARITABLE POLICY GUIDELINES: PROGRAM CIRCULAR 19 (2018), <https://www.fidelitycharitable.org/docs/Giving-Account-Policy-Guidelines.pdf> [https://perma.cc/RG75-CNGP].

171. *Id.*

172. *Id.*

charity.<sup>173</sup> But while Fidelity Charitable requires donors to advise grantmaking on a regular basis, it has no guidelines for how large the grant must be.<sup>174</sup> So, while Fidelity Charitable requires donors to donor-advised funds to recommend regular distributions, it also allows donors to keep virtually all of their donated money in the funds.

*B. Donor-Advised Funds and the Erosion of Public Support*

Donor-advised funds effectively undermine the traditional division between public charities and private foundations. They do this by allowing donors to accelerate their charitable deductions without facing the deductibility limitations and excise taxes of private foundations. But donor-advised funds also break down the differences between public charities and private foundations in another way: donors can also use donor-advised funds to skirt the public support requirements for public charities.

Certain exempt organizations always qualify as public charities. The Code lists a number of tax-exempt organizations that automatically qualify as public charities, not private foundations.<sup>175</sup> These statutory public charities include, among other things, churches, educational institutions (provided they have faculty, students, and a location), organizations that provide medical care or education (if the organization is a hospital or is associated with a hospital), and organizations that receive a substantial portion of their support from the government and the general public.<sup>176</sup>

Other unenumerated tax-exempt organizations can also qualify as public charities. To qualify, a tax-exempt organization must receive more than one-third of its support from donors who are not disqualified persons, from certain governmental units, and from tax-exempt organizations that automatically qualify as public charities.<sup>177</sup> “Disqualified persons” include managers of, and substantial contributors to, the exempt organization.<sup>178</sup> A donor becomes a substantial contributor if her donations exceed \$5000 in a

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173. *Id.*

174. Or, at least, it has very few guidelines. A grant must be at least \$50 or the balance of the account and above \$50; Fidelity Charitable requires that grants be made in \$5 or \$18 increments. *Id.* The \$18 increments, Fidelity Charitable explains, are because that “number has cultural significance for some donors.” *Id.* In fact, in the Jewish community in the United States, charitable donations are commonly made in multiples of \$18 because the number eighteen represents “living or ‘life,’ a notion reinforced by the traditional concept that charity wards off death.” SOL STEINMETZ, *DICTIONARY OF JEWISH USAGE: A GUIDE TO THE USE OF JEWISH TERMS* 25 (2005).

175. I.R.C. §§170(b)(1)(A), 509(a)(1) (2018).

176. *Id.* §§ 170(b)(1)(A), 509(a)(1).

177. *Id.* § 509(a)(2).

178. *Id.* §4946(a)(1)(A)–(B).

taxable year and represent more than 2 percent of the total donations the organization receives during the year.<sup>179</sup>

In calculating whether a tax-exempt organization meets the one-third public support requirement for public charities, the tax-exempt organization includes all of its grants in the denominator, but it must exclude donations from disqualified persons from the numerator.<sup>180</sup> Donations from disqualified persons thus reduce the chances that a tax-exempt organization will meet the public support requirement, making it harder for an organization to achieve public charity status.

The sponsor of a donor-advised fund qualifies as an enumerated public charity, a result of it receiving a substantial portion of its support from the general public.<sup>181</sup> As a public charity, donations from a donor-advised fund will not be treated as donations from a disqualified person and will not face the 2 percent limitation.<sup>182</sup> The Treasury regulations recognize that disqualified persons could try to launder their donations through public charities and recharacterize indirect contributions as being contributions directly from the disqualified person.<sup>183</sup> An indirect contribution is one “which is expressly or impliedly earmarked by the donor as being for . . . a particular recipient.”<sup>184</sup> In the case of a donor-advised fund, the contribution would probably not qualify as expressly or impliedly earmarked. The donor gives the money and advises the sponsor to give it to a particular recipient but has no legal ability to require that the sponsor follow her advice.<sup>185</sup>

The IRS has recognized the potential of this type of evasion. To avoid abuse of this kind, it is currently considering “treating, solely for purposes of determining whether the distributee charity qualifies as publicly supported, a distribution from a [donor-advised fund] as an indirect contribution from the donor (or donors) that funded the [donor-advised fund] rather than as a contribution from the sponsoring organization.”<sup>186</sup> Until it does so, however, board members and substantial donors have the ability to, for only a marginal additional cost, give through a donor-advised fund rather

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179. *Id.* §§ 507(d)(2)(A), 4946(a)(2).

180. Treas. Reg. § 1.509(a)-3(j)(1) (as amended in 2011) (“[I]f . . . the donor is a substantial contributor . . . with respect to the ultimate recipient, such amount shall be excluded from the numerator of the support fraction under section 509(a)(2).”).

181. *See* I.R.C. § 170(b)(1)(A)(vi); *see also* I.R.S. Notice 2017-73, 2017-51 I.R.B. 562, 566 (“Because of the contributions they receive from the general public, DAF sponsoring organizations typically qualify as § 170(b)(1)(A)(vi) organizations whose distributions from DAFs would ordinarily be counted as public support without limitation to the distributee charity.”).

182. *See* I.R.C. § 509(a)(2)(A); Treas. Reg. § 1.509(a)-3(j)(1).

183. Treas. Reg. § 1.509(a)-3(j)(1).

184. *Id.* § 1.509(a)-3(j)(2).

185. *See supra* notes 101–03 and accompanying text.

186. I.R.S. Notice 2017-73, *supra* note 181, at 566.

than directly without compromising a tax-exempt organization's ability to qualify as a public charity.

Why did Congress decide that a public charity needed to derive one-third of its income from the general public? When Congress created the split between public charities and private foundations, it explained that it designed the one-third public support requirement "to insure that the organization is responsive to the general public."<sup>187</sup> It makes sense that Congress would want public charities to be accountable to the general public.<sup>188</sup> After all, allowing donors to deduct up to 60 percent of their adjusted gross income represents both a significant subsidy of the charity's mission<sup>189</sup> and a significant amount of foregone federal revenue.<sup>190</sup>

Congress imposed a level of accountability on private foundations through the series of excise taxes they have to pay if they act in undesirable ways.<sup>191</sup> Public charities face far fewer explicit legal constraints. Congress believed that "dependence on public support and accompanying public scrutiny would prevent" public charities from abusing their charitable funds.<sup>192</sup>

Allowing contributions from a donor-advised fund to qualify as public contributions risks short circuiting this quasi-regulatory

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187. STAFF OF JOINT COMM. ON INTERNAL REVENUE TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 58 (Comm. Print 1970).

188. See Miriam Galston, *Lobbying and the Public Interest: Rethinking the Internal Revenue Code's Treatment of Legislative Activities*, 71 TEX. L. REV. 1269, 1303 n.94 (1993).

189. Herzog & Brunson, *supra* note 16, at 1114 ("[T]here is little debate that the deduction for charitable donations is a subsidy.").

190. In 2018, the Treasury Department estimated that the charitable deduction represented a tax expenditure (that is, foregone revenue) for that year of over \$56 billion. OFFICE OF TAX ANALYSIS, U.S. DEP'T OF THE TREASURY, TAX EXPENDITURES 24–25 (2018), <https://home.treasury.gov/system/files/131/Tax-Expenditures-FY2020.pdf> [<https://perma.cc/6RWK-6QQ2>]. While the Treasury tax expenditure budget does not differentiate charitable deductions for donations to public charities from charitable deductions for donations going to private foundations, it is possible to get a rough idea of the cost of donations to private foundations. In 2015, private foundations received donations worth about \$61 billion. STATISTICS OF INCOME DIV., IRS, DOMESTIC PRIVATE FOUNDATIONS: NUMBER AND SELECTED FINANCIAL DATA, BY TYPE OF FOUNDATION AND SIZE OF FAIR MARKET VALUE OF TOTAL ASSETS, TAX YEAR 2015 (2018), <https://www.irs.gov/pub/irs-soi/15pf01ta.xls> [<https://perma.cc/7HEX-2RS5>]. Assuming those donations were fully deductible, and that the donors were in the top tax bracket, donations to private foundations in 2015 reduced government revenue by about \$24 billion.

191. See *supra* notes 65–79 and accompanying text.

192. Alyssa A. DiRusso, *Supporting the Supporting Organization: The Potential and Exploitation of 509(A)(3) Charities*, 39 IND. L. REV. 207, 211 (2006). While this was Congress's theory, it is not a foregone conclusion. Shortly after Congress enacted the public support rule, one legal commentator asked how realistic it was to "assume that publicly-supported organizations are in general performing their obligations with more propriety and skill than foundations[.]" Richard D. Kahn, *Regulation of Privately Supported Foundations: Some Anomalies*, 4 IND. LEGAL F. 271, 280–81 (1970).

regime. A tax-exempt organization would not have to raise one-third of its support from the general public. Rather, it could receive most—if not all—of its support from a single individual, provided that the individual made her donations through a donor-advised fund. Unless the IRS follows its recognition of this potential problem with action, donor-advised funds could allow public charities to operate without the explicit constraints imposed on private foundations *and* without the public accountability that comes from soliciting donations from the general public.

*C. Using Donor-Advised Funds to Meet the Distribution Requirement*

The tax law requires private foundations to make a minimum annual distribution.<sup>193</sup> Under current law, that minimum annual distribution is 5 percent of the fair market value of its assets, with certain minor adjustments.<sup>194</sup> If a private foundation distributes less than the required amount, it has to pay an excise tax equal to 30 percent of its under-distribution.<sup>195</sup>

The tax law allows a broad range of distributions to qualify as part of the minimum annual distribution. In general, any amount that the private foundation distributes to accomplish one or more charitable purposes—including many administrative expenses—counts toward the 5 percent minimum distribution.<sup>196</sup> The law carves out exceptions from qualifying distributions, including any distribution to another private foundation and any distribution to an organization controlled by the private foundation or by disqualified persons of the distributing private foundation.<sup>197</sup>

The carve outs make sense. The purpose behind the private foundation distribution requirement was to ensure that deductible charitable money found its way into active philanthropic endeavors.<sup>198</sup> Because the private foundation rules allowed for an immediate deduction even though private foundations do not directly provide charitable services, the excise tax discourages private foundations from keeping their funds out of active charities indefinitely.

A private foundation can get around this distribution requirement and avoid the excise tax by making donations to donor-advised funds that qualify as part of the minimum annual distribution.<sup>199</sup> Donor-advised funds qualify as public charities,<sup>200</sup> so

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193. See *supra* notes 69–70 and accompanying text.

194. I.R.C. § 4942(d), (e)(1) (2018).

195. *Id.* § 4942(a).

196. Treas. Reg. § 53.4942(a)-3(a)(2)(i) (as amended in 2015).

197. *Id.* § 53.4942(a)-3(a)(2)(i)(a)-(b).

198. See *supra* notes 67–69 and accompanying text.

199. See Colinvaux, *supra* note 145, at 1011.

200. See *supra* note 120 and accompanying text.

distributions to donor-advised funds are not disqualified under the first exception. Further, for the private foundation or its disqualified persons to “control” the donor-advised fund, they would have to have the authority to “require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure.”<sup>201</sup> While donors to donor-advised funds can *recommend* investments and charitable distributions, they lack the legal authority to require the donor-advised fund to make a distribution.<sup>202</sup> As a result, “[f]oundation-to-[donor-advised fund] grants are yet another way that money can remain under effective control of the donor without getting to working charities.”<sup>203</sup> Again, the unique structure of a donor-advised fund—which looks in many ways like a private foundation but is treated as a public charity—provides a way for donors to accelerate their charitable deduction while effectively keeping the money away from functioning charities.

## VI. FIXING THE PROBLEMS

The problems with the tax treatment of donor-advised funds—especially the risk that they will not make distributions—are well understood by policymakers and commenters. They broadly recognize that the status quo is not optimal for many of the reasons discussed above. As a result, these policymakers and commenters have made a number of proposals intended to either encourage donor-advised funds to make distributions or to better align charitable deductions and the actual charitable use of their donations. However, these proposed changes would have concomitant problems that make them less desirable. This Part will discuss the strengths and weaknesses of some of the proposals, and Part VII will then propose an alternative regime that would deal with the current problems inherent to donor-advised funds.

### A. *Pension Protection Act of 2006*

Historically, tax law has largely ignored donor-advised funds, allowing them to function without specific legislation or regulation aimed at them.<sup>204</sup> President Clinton proposed legislation, but Congress did not act on his recommendation.<sup>205</sup> Then, in the mid-2000s, the IRS listed donor-advised funds in its “dirty dozen tax scams” but “offered no specific information justifying including donor-advised funds in the list.”<sup>206</sup>

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201. Treas. Reg. § 53.4942(a)-3(a)(3).

202. See *supra* notes 101–03 and accompanying text.

203. Colinvaux, *supra* note 145, at 1011.

204. Coverdale, *supra* note 104, at 821 (“Despite the potential for abuse of donor-advised funds, for many years neither the government nor the public showed any interest in regulating them.”).

205. *Id.* at 823.

206. *Id.*

Still, in 2006, Congress worked to rein in perceived abuses of donor-advised funds.<sup>207</sup> As part of the Pension Protection Act of 2006,<sup>208</sup> it created “penalty excise taxes that apply only to donor-advised funds and supporting organizations, and not to other public charitable organizations.”<sup>209</sup>

These penalty excise taxes discouraged two potential abuses by donors to, or sponsors of, donor-advised funds. The first is an excise tax on “taxable distributions.”<sup>210</sup> Taxable distributions include any distributions to individuals or to nonexempt organizations.<sup>211</sup> If a donor-advised fund makes a taxable distribution, the sponsoring organization owes an excise tax of 20 percent of the taxable distribution.<sup>212</sup> In addition, if any fund manager agrees to the distribution (while knowing that it is a taxable distribution), the fund manager owes an excise tax of 5 percent.<sup>213</sup>

The second excise tax Congress created for donor-advised funds is a tax on prohibited benefits.<sup>214</sup> This excise tax applies when a donor-advised fund makes a distribution that benefits the donor—or certain other people related to the donor or the fund—directly or indirectly.<sup>215</sup> If it makes such a distribution, the person who advised the fund to make the distribution, or the person who received the benefit of the distribution, owes an excise tax of 125 percent of the benefit received.<sup>216</sup> In addition, as with the first excise tax, a manager who approves the distribution knowing that it would confer a prohibited benefit must pay an excise tax of 10 percent of the benefit.<sup>217</sup>

It is not clear that these targeted excise taxes were entirely necessary. Because donor-advised funds occupied a niche somewhere between traditional public charities and traditional private foundations, they were subject to the potential abuses of both, but without the regulation that reined in such abuses.<sup>218</sup> Still, the IRS had general tools to prevent the worst abuses by donor-advised

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207. *Id.* at 827 (“The Pension Protection Act of 2006 created for the first time a statutory category for donor-advised funds and applied to them a set of provisions intended to prevent abuses.”).

208. Pub. L. No. 109-280, 120 Stat. 780, 1094–102 (2006) (codified as amended in scattered sections of 26 U.S.C.).

209. Knoepfle, *supra* note 127, at 223.

210. I.R.C. § 4966 (2018).

211. *Id.* § 4966(c)(1).

212. *Id.* § 4966(a)(1).

213. *Id.* § 4966(a)(2).

214. *Id.* § 4967.

215. *Id.* § 4967(a)(1).

216. *Id.*

217. *Id.* § 4967(a)(2).

218. See Coverdale, *supra* note 104, at 821.

funds,<sup>219</sup> and there was no reason to believe that taxpayers were systemically abusing donor-advised funds.<sup>220</sup>

Whatever the benefits of these excise taxes were, they do not address the use of donor-advised funds either to accelerate charitable deductions or to avoid private foundation status. As a result, the sole piece of federal legislation addressing donor-advised funds does nothing to ensure that charitable dollars get to charities in a timely manner.<sup>221</sup>

### B. *Tax Reform Act of 2014*

Shortly before stepping down as the Chair of the House Ways and Means Committee, Representative Dave Camp introduced the Tax Reform Act of 2014.<sup>222</sup> Proposed as a baseline for future tax reform, the centerpiece of the Camp proposal involved simplifying the tax law, broadening the tax base, and lowering tax rates.<sup>223</sup> But the 979-page bill did more than merely eliminate deductions and lower rates.<sup>224</sup> Among other things, it addressed the problem of donor-advised funds holding onto their money rather than distributing that money to functioning charities.<sup>225</sup>

The Camp proposal required donor-advised funds to distribute all of their contributions to eligible recipients within five years of receipt.<sup>226</sup> To the extent that any contributions remained in the

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219. See Knoepfle, *supra* note 127, at 223 (“In fact, the IRS already had every tool it needed to monitor, regulate, and sanction donor-advised funds and supporting organizations.”).

220. See Coverdale, *supra* note 104, at 811 (“Congress paid no attention to [donor-advised funds] until articles appeared in the press alleging abuses at a small number of donor-advised funds.”).

221. Recently, there has been some state interest in regulating donor-advised funds, too. On February 22, 2019, California Assembly Member Buffy Wicks introduced AB 1712. Assembly Member Wicks was concerned both about the lack of transparency, oversight, and accountability of donor-advised funds and donor-advised funds failing to provide the benefits that donations to public charities provide. Assemb. B. 1712, 2019–20 Reg. Sess. (Cal. 2019) (as reported by Cal. Leg., Feb. 22, 2019). Because the Assembly did not pass the proposed bill by January 31, 2020, the Assembly lost the ability to act upon the bill under California’s constitution. *Id.* For now, then, the bill is dead.

222. Jason S. Oh, *Will Tax Reform Be Stable?*, 165 U. PA. L. REV. 1159, 1185 (2017).

223. See Martin A. Sullivan, *All Roads Lead to VAT, Commentary on: The Saga of Unfulfilled Business Income Tax Reform by Harry L. Gutman*, 89 TEMP. L. REV. 341, 347 (2017) (“Though his plan eliminated and downsized dozens of tax breaks, he was only able to reduce the top individual rate to 35% and the corporate rate to 25%.”).

224. *Id.*

225. See Tax Reform Act of 2014, H.R. 1, 113th Cong. § 5203 (2014).

226. *Id.* Three years prior to Camp’s bill, Professor Ray Madoff suggested a similar solution to the problem of donor-advised funds not making sufficient distributions. Under Professor Madoff’s proposal, donor-advised funds would have to distribute donations they received within seven years of receipt. Ray D. Madoff, *It’s Time to Reform Donor-Advised Funds*, 133 TAX NOTES 1265, 1270

donor-advised fund after five years, the sponsoring organization would have to pay an annual 20 percent tax on the undistributed amount.<sup>227</sup> Camp's proposal for donor-advised funds reflected the early twentieth century discomfort with endowment building.<sup>228</sup>

The Camp proposal would likely be effective at incentivizing donor-advised funds to make substantial distributions of their assets to public charities. The cost of holding assets for more than five years—the 20 percent excise tax—almost certainly exceeds the return the sponsoring organization could earn holding those assets instead.<sup>229</sup>

The Camp proposal suffers from at least two significant problems. First, while it remedies the issue of donor-advised funds failing to distribute their assets to public charities, it does nothing to solve the problem of donors using donor-advised funds to circumvent the public support requirement.<sup>230</sup> Because donor-advised funds would continue to qualify as public charities, their donations would continue to count as public support in determining whether a tax-exempt organization qualifies as a public charity.<sup>231</sup>

Second, the proposal adds unnecessary complexity to the Code. The tax law already classifies charities into a public charity basket and a private foundation basket and provides a different set of rules for each.<sup>232</sup> The Camp proposal introduces a brand new regime for donor-advised funds, different from that governing both public charities and private foundations, adding to the complexity of the tax law.<sup>233</sup> Public charities have no distribution requirement, while private foundations must distribute 5 percent of their assets annually.<sup>234</sup> The Camp proposal would introduce a third regime, one requiring the distribution of *all* assets within five years, to the already extant regimes.<sup>235</sup>

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(2011). Professor Roger Colinvaux also recently embraced this mandatory distribution idea, recommending that the law require donor-advised funds to distribute their assets within five to seven years after receiving them. Colinvaux, *supra* note 145, at 1011.

227. H.R. 1 § 5203. Because the donor would presumably make periodic donations, the law would treat distributions on a first-in, first-out basis. *Id.*

228. Berman, *supra* note 135, at 1467–68.

229. Between 1926 and 2001, the median rate of return was 10.5 percent. Howell E. Jackson, *To What Extent Should Individual Investors Rely on the Mechanisms of Market Efficiency: A Preliminary Investigation of Dispersion in Investor Returns*, 28 J. CORP. L. 671, 674 (2003).

230. *See infra* Subpart V.B.

231. The Camp proposal did ensure that donor-advised funds could not just pass their assets on to other donor-advised funds. The bill carved donor-advised funds out of the list of organizations that could receive qualifying distributions. H.R. 1 § 5203 (excluding “any fund or account described in section 4966(d)(2)”).

232. *See supra* notes 58–66 and accompanying text.

233. *See* H.R. 1 § 5203.

234. I.R.C. § 4942(d), (e)(1) (2018).

235. H.R. 1 § 5203.

In general, sound tax policy seeks to avoid complexity where possible.<sup>236</sup> While complexity may be justified in certain circumstances, having fewer regimes is generally better than having more.<sup>237</sup> A requirement that donor-advised funds distribute all of their receipts within five years may discourage donors from giving to donor-advised funds, shifting their deferred donations instead into private foundations—or perhaps even discouraging them from giving at all. Donor-advised funds clearly differ from private foundations and public charities. It is not clear, however, that these differences are so profound that the benefits of having a distribution requirement that only applies to donor-advised funds outweighs the costs.

Ultimately, while the Camp proposal would effectively encourage donor-advised funds to make distributions of their assets to public charities, it does not appear to be an optimal solution to the problems presented by donor-advised funds. It does not address the public support problem and, while it solves the problem of nondistribution, it does so in a manner that adds unnecessary complexity to the tax law and to donors' decisions of how to give.

### C. *Delay the Deduction*

Professor Roger Colinvaux proposes an elegant solution to the problem of donor-advised funds holding assets rather than distributing them to public charities. Professor Colinvaux would delay a donor's tax deduction until the donor-advised fund distributed the donation to an eligible recipient.<sup>238</sup> He argues that “[d]elaying the charitable deduction until the [donor-advised fund’s] distribution would likely be as effective as a payout, if not more so, at speeding up distributions.”<sup>239</sup> To the extent that a donor's willingness to make charitable contributions is influenced by her desire to get a deduction, aligning the year of the deduction with the year of the distribution will provide her with an incentive to recommend distributions sooner rather than later.

Professor Colinvaux acknowledges that his proposal would likely “have the effect of ending the main appeal of” donor-advised funds: the accelerated deduction.<sup>240</sup> He is fine with that result, at least as

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236. In 1998, Congress required the IRS to provide a report to Congress that included sources of complexity in the Code and recommendations for how to reduce that complexity. Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 4022(a), 112 Stat. 685, 785.

237. Cf. David J. Herzig & Samuel D. Brunson, *Tax Exemption, Public Policy, and Discriminatory Fraternities*, 35 VA. TAX REV. 116, 143 (2015) (“[I]mporting the standard from section 501(c)(3) would reduce complexity. . . . That single standard would also provide nonprofit clubs with a larger body of precedent that such nonprofit clubs could look to in understanding what behaviors the tax law proscribed, if they wanted to maintain their exemption.”).

238. Colinvaux, *supra* note 94, at 70.

239. *Id.* at 71.

240. *Id.*

long as giving to donor-advised funds merely substitutes for other forms of charitable giving.<sup>241</sup>

In spite of its elegance, the downsides to this proposal are similar to those of the Camp proposal. Like the Camp proposal, it does nothing to address the use of donor-advised funds to evade the public support requirement. Even with the date of the deduction deferred until the date of distribution, donors could use donor-advised funds to transform their support of a tax-exempt organization into public support.

Much like the Camp proposal, this proposal creates a third regime, adding to the complexity of the tax law. In addition to legal complexity, the proposal would add some amount of administrative complexity, requiring the sponsoring organization to notify donors when it made distributions from their funds, a requirement that would not apply to similarly situated private foundations.<sup>242</sup>

#### VII. CHARACTERIZING DONOR-ADVISED FUNDS AT THE SEGREGATED ACCOUNT LEVEL

The problems of donor-advised funds arise from the fact that they largely function as miniature private foundations, but the tax law treats them as public charities. This mismatch underlies both donors' ability to take a charitable deduction—potentially significantly in advance of their donation's use for charitable purposes—and donors' ability to use donor-advised funds to circumvent the public support requirement.

Being treated as public charities allows donor-advised funds to escape much of the regulation and excise taxation that ensures that private foundations do not abuse their tax exemption and further allows donors to enjoy the higher deduction limitations. An easy—and effective—way to solve all of these problems would be to treat donor-advised funds like private foundations for tax purposes.

Before detailing how and why, it is worth acknowledging that donor-advised funds are not just miniature private foundations.

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241. *See id.* at 71 (“[T]his is not necessarily a bad result, except to the extent that [donor-advised fund] contributions represent new giving.”).

242. *Id.* at 70. While charitable deductions are meant to encourage donors to give money to organizations that engage in active charity, it is not completely clear that the tax law should disallow charitable deductions until the money gets into the hands of an active charity. While that question is beyond the scope of this Article, Professor Daniel Hemel asks whether we would prefer that wealthy taxpayers rush into making donations before December 31 so that they can get a current deduction, or whether we “prefer that they have time to consider where their \$\$\$ can be most useful[.]” Daniel Hemel (@DanielJHemel), TWITTER (Feb. 26, 2019, 11:06 AM), <https://twitter.com/DanielJHemel/status/1100472248337645569?s=20> [<https://perma.cc/N8FH-FAAE>]. Allowing a current deduction for donations to private foundations and donor-advised funds, even if that delays public charities' receipt of the donations, may have some benefits.

There are very real differences between the two charitable vehicles. The costs of establishing and running a donor-advised fund are far lower for individual donors than the costs of establishing and running a private foundation.<sup>243</sup> And while donors to a donor-advised fund can advise the sponsoring organization on how to distribute their donated money, donors have no legal authority to distribute the money once it has been donated.<sup>244</sup>

Despite those differences, donor-advised funds look more like private foundations than like public charities. Their purpose is to receive charitable donations and distribute those assets to operating charities rather than to engage in charitable activities themselves. Even if donors have no *legal* authority to direct their fund's distributions, sponsoring organizations have a strong incentive to follow the donor's recommendations.<sup>245</sup> Ultimately, shifting their treatment into the private foundation regime—rather than creating a brand new regime for a vehicle that shares the majority of its DNA with private foundations—does not add more complexity to the tax rules surrounding tax-exempt organizations. In other words, while the private foundation rules are not a perfect match, they are a good-enough match. In the case of donor-advised funds, *good enough* is better than perfect, because a good-enough solution does not add the additional complexity that a tailored approach to donor-advised funds would add.

#### A. *Miniature Private Foundations*

While donor-advised funds share the same uses as private foundations, they clearly qualify under current law as public charities.<sup>246</sup> Each donor's donation is placed in its own segregated account, and each sponsoring organization manages segregated accounts from multiple donors.<sup>247</sup> However, the segregated accounts are merely bookkeeping annotations, illusory as a legal matter. Donors make their donations to the sponsoring organization<sup>248</sup> and, because the sponsoring organization receives more than one-third of its donations from the general public, it qualifies as a public charity.<sup>249</sup>

Simply adding a new subsection stating that, public support notwithstanding, donor-advised funds will be treated as private foundations is not a good solution. As with other proposals, that

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243. See *supra* notes 95–98 and accompanying text.

244. See *supra* notes 101–03 and accompanying text.

245. See *supra* note 103 and accompanying text.

246. See *supra* note 123 and accompanying text.

247. See *supra* notes 102–04 and accompanying text.

248. See I.R.C. § 170(f)(18)(B) (2018) (requiring donors to donor-advised funds to receive acknowledgment from the sponsoring organization that the sponsoring organization has “exclusive legal control over the assets contributed”).

249. *Id.* § 170(b)(1)(A)(vi).

would create a new regime, putting pressure on the definition of a donor-advised fund and adding complexity to the tax law. A better solution would work within the confines of what already exists.

Instead of just declaring that the tax law will treat donor-advised funds as private foundations, it should look at donor-advised funds at the segregated account level rather than the sponsoring organization level. If a donor-advised fund qualified at the segregated account level as a public charity (because, for instance, it had broad public support), that particular segregated account would continue to be treated as a public charity. If it did not, it would be treated as a private foundation.

Evaluating the status of donor-advised funds at the segregated account level would provide several benefits. It would maintain the two-tier structure that the current tax law already provides. Donors and sponsoring organizations would not have to learn a new regime. Instead, they—as well as the IRS and the courts—would be able to draw from half a century's worth of precedent in structuring and operating the funds.

Looking at donor-advised funds at the segregated account level would also address the question of distributions. The tax law requires private foundations to distribute 5 percent of their assets annually.<sup>250</sup> Whether the 5 percent distribution requirement is too low,<sup>251</sup> too high,<sup>252</sup> or just right is beyond the scope of this discussion. What is important, for the sake of simplicity and fairness, is that the distribution requirement be consistent between donor-advised funds and private foundations. If policymakers determine that the distribution requirement should increase to 10 percent or that all assets should be distributed within five years of their contribution, it can do that by changing the private foundation rules. Any donor-advised fund categorized as a private foundation would automatically face the same distribution requirement.

Classifying donor-advised funds at the segregated account level would also mean that the other restrictions on, and obligations of, private foundations would apply to donor-advised funds that fail to qualify as public charities. In fact, the general rules applicable to private foundations would probably render the donor-advised fund excise taxes superfluous and allow Congress to remove them.

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250. See *id.* § 4942(d), (e)(1).

251. See Eric Franklin Amarante, *The Perils of Philanthrocapitalism*, 78 MD. L. REV. 1, 49 (2018) (“When considering all of the generous tax benefits enjoyed by private foundations, one might reasonably conclude that the mandatory distribution requirement is not commensurate with the potential forgone tax revenue.”).

252. See Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 286–87 (2011) (“I believe mandating a certain level of distributions to be unwise since it is both disruptive and unlikely to succeed in reducing accumulation.”).

Classifying donor-advised funds at the segregated account level solves the problem of using donor-advised funds to circumvent the public support and the private foundation distribution rules.<sup>253</sup> Donations from private foundations generally do not qualify as public support for purposes of qualifying as a public charity.<sup>254</sup> And private foundations cannot count distributions to other private foundations in calculating their qualifying distributions.<sup>255</sup> Provided it is viable to treat each segregated account separately, evaluating whether donor-advised funds qualify as public charities on an account-by-account basis will solve many of the problems that the current liminal treatment of donor-advised funds raises.

### B. *The Community Trust Rules*

The question of whether to treat separate accounts individually or collectively in determining public charity status is far from novel. Community trusts faced this question decades ago, and the IRS enacted regulations to determine whether to treat a community trust as a unified tax-exempt organization (and thus probably a public charity) or a series of atomized organizations (most likely private foundations).<sup>256</sup>

For a community trust to be treated as a single entity, it has to meet several criteria. The fund must be created by a gift or other type of gratuitous transfer and cannot be subject to material conditions or restrictions.<sup>257</sup> The organization must “be commonly known as a community trust, fund, foundation, or other similar name.”<sup>258</sup> The funds must all be governed by a common instrument, and the organization must have a distribution committee or governing body in common.<sup>259</sup> If the community trust meets all of these requirements then, for tax purposes, it will be treated as a single entity in determining whether it has sufficient public support to qualify as a public charity.<sup>260</sup>

This set of regulations feels odd: why would the default treatment not be as a single entity? After all, single-entity treatment appears to be the default and is why donors can use donor-advised funds to

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253. Classifying donor-advised funds at the segregated account level would also effectively address the question of using donor-advised funds to accelerate charitable deductions without a concomitant benefit to society by subjecting them to the same rules as private foundations.

254. See I.R.C. § 170(b)(1)(A)(vi); see also *St. John's Orphanage, Inc. v. United States*, 16 Cl. Ct. 299, 302 (1989) (“Only contributions which come *directly* from the general public or from other publicly supported organizations qualify as public support.”).

255. See I.R.C. § 4942(g)(1)(A).

256. See Colinvaux, *supra* note 99, at 18.

257. Treas. Reg. § 1.170A-9(f)(11)(ii) (as amended in 2011).

258. *Id.* § 1.170A-9(f)(11)(iii).

259. *Id.* § 1.170A-9(f)(11)(iv)–(v)(A).

260. *Id.* § 170A-9(f)(11)(i).

circumvent the public support rules, as well as control and distribution rules. It turns out that these regulations “were written for community foundations as they existed in 1969,” not for modern donor-advised funds.<sup>261</sup> Under the community trust model the regulations addressed, the community trust functioned as an umbrella over individual trusts, each of which existed as an independent entity and held title to its own assets.<sup>262</sup> Because the donations were “often received and maintained in the form of separate trusts or funds,”<sup>263</sup> each trust and fund would have to qualify separately as a public charity or face the limitations and regulation of private foundations.<sup>264</sup> The regulations provide a subject-over-form rule that allows community foundations that exercise sufficient control over the putatively independent trusts and funds to be treated as a single entity.<sup>265</sup>

On the surface, these regulations appear to provide a path forward for determining whether to treat donor-advised funds as a single entity or as an agglomeration of separate entities. Despite that surface-level similarity, ultimately the community trust regulations are inapposite to the question of donor-advised funds. The regulations were enacted to address almost precisely the opposite question from the one donor-advised funds raise. After all, the separate accounts that make up donor-advised funds are merely bookkeeping entries of a larger entity. Because of that, and absent some kind of contractual agreement with donors, a donor-advised fund will always meet the criteria in the community trust regulations. Further, due to the structure of those accounts and the fact that the sponsoring organization actually owns the donated property and can exercise legal control over the property, the sponsoring organization can also exercise legal control over those accounts. While the community trust regulations do not solve the question of how to treat donor-advised funds, they suggest that some kind of subject-over-form analysis would be appropriate in this context.

Ultimately, the community trust regulations provide support for the idea of looking to substance rather than form when determining the tax consequences that inure to donor-advised funds. But those regulations do far less in providing an outline for what the tax law should do to ensure that donor-advised funds make charitable distributions or to prevent donors from using donor-advised funds to circumvent the private foundation rules. The reason these regulations fail to do those things is because they were designed and

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261. George Johnson & David Jones, *Community Foundations*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1994, at pt. 2.C (1993), <https://www.irs.gov/pub/irs-tege/eotopick94.pdf> [<https://perma.cc/LTK6-EDSJ>].

262. Colinvaux, *supra* note 99, at 18.

263. Treas. Reg. § 1.170A-9(f)(10).

264. *Id.*

265. Colinvaux, *supra* note 99, at 18.

enacted as a taxpayer-favorable regime. Treating separate entities as a single entity increases the likelihood that they will meet the public support requirements and thus qualify as public charities.

Donor-advised funds present essentially the opposite situation from the one the community trust regulations were meant to deal with. Instead of several entities being treated as a single entity, a current donor-advised fund is a single entity (with multiple accounts) that largely functions as though each account is a separate entity. The theory underlying the community trust regulations—that is, looking to the substance, not the form, of the funds—applies here, but it should play out differently. Instead of treating qualifying separate entities as a single entity, it should look to whether a putatively single entity should be treated as separate entities.

### C. *Substance over Form with Donor-Advised Funds*

Even if a subject-over-form rule is an appropriate way to address donor-advised funds, the question of whether treating each account separately is a viable solution—or whether that type of artificial separation will be unadministrable and add unnecessary complexity to the tax law—remains. The answer is, not only is such treatment administrable, but the IRS already has experience treating single entities as multiple entities for tax purposes.<sup>266</sup>

In 1996, Delaware became the first state to allow series limited liability companies (“LLCs”).<sup>267</sup> A series LLC can designate different series within the entity that each hold separate assets or engage in

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266. While administrable, treating each separate account as a separate entity will increase the costs associated with donor-advised funds. Instead of the sponsoring organization filing a single Form 990, each separate account would have to file its own tax return. The IRS estimates that it requires 32.7 hours to file a Form 990-PF and that it costs \$932 to do so. *Instructions for Form 990-PF (2019)*, IRS, <https://www.irs.gov/pub/irs-pdf/i990pf.pdf> (last visited May 1, 2020) [<https://perma.cc/ZLP3-BL27>]. For a donor-advised fund with only \$5000, that would be a crushing burden. The IRS could solve that problem, though. In 2007, the IRS introduced Form 990-N, a simplified information return for small tax-exempt organizations (excluding private foundations). Mathew Encino, *Holy Profits: How Federal Law Allows for the Abuse of the Church Tax-Exempt Status*, 14 HOUS. BUS. & TAX L.J. 78, 89 (2014). Tax-exempt organizations other than private foundations with annual revenue of \$50,000 or less and assets of \$250,000 or less qualify to file the Form 990-N. Evelyn Brody & Marcus Owens, *Exile to Main Street: The I.R.S.'s Diminished Role in Overseeing Tax-Exempt Organizations*, 91 CHI.-KENT L. REV. 859, 881 (2016). The IRS estimates that the Form 990-N takes two hours to complete and costs \$10. *Instructions for Form 990-PF (2019)*, *supra*. Because private foundations tend to be larger to justify their cost and administrative burden, *see supra* note 95 and accompanying text, there has been no need for a similar simplified information return. To the extent that smaller donor-advised funds would begin to qualify as private foundations, though, it may make sense to provide a similar simplified information return for smaller private foundations.

267. Michael E. Mooney, *Series LLCs: The Loaves and Fishes of Subchapter K*, 116 TAX NOTES 663, 664 n.9 (2007).

different businesses.<sup>268</sup> Each series has its own debts and liabilities, and the debts and liabilities in one series are not enforceable against the debts and liabilities of the LLC's other series.<sup>269</sup>

In spite of having separate series, a series LLC is a single entity for state law purposes, and thus each of the various series cannot have different members.<sup>270</sup> Each series is associated with one or more members, and income from a particular series is allocated and distributed only to those members associated with that series.<sup>271</sup> Similarly, while all members are technically members of the series LLC itself, only those members associated with a particular series can have any management rights in that series.<sup>272</sup>

How the tax law would approach series LLCs remained an open question for almost a decade and a half.<sup>273</sup> Would they be taxed as a single entity despite the fact that they allocated and distributed their income based on a member's association with a separate series?<sup>274</sup> Would each series be treated as a separate entity in spite of the fact that the series were not individual entities?<sup>275</sup>

In 2010, the Treasury released proposed regulations to answer these questions.<sup>276</sup> Under the proposed regulations, the tax law would treat each series of a domestic series LLC as a separate entity for tax purposes.<sup>277</sup> Only the members associated with that particular series would face tax consequences from that particular series' income, loss, and other tax attributes.

A series LLC is clearly not identical to a donor-advised fund. Series LLCs involve actual equity ownership with an associated economic interest, something tax-exempt organizations cannot have.<sup>278</sup> But in many ways, they are analogous. A series LLC is a single entity that allocates certain assets to some, but not all, of its members.<sup>279</sup> Likewise, a donor-advised fund associates particular

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268. *Id.* at 664.

269. *Id.*

270. Series LLCs and Cell Companies, 75 Fed. Reg. 55,699, 55,699 (proposed Sept. 14, 2010) (to be codified at 26 C.F.R. pt. 301). "Members" of an LLC are the equity owners of that LLC. Lila L. Inman, Note, *Personal Enough for Protection: The Fifth Amendment and Single-Member LLCs*, 58 WM. & MARY L. REV. 1067, 1087 (2017) ("The LLC's equity interest owner . . . is referred to as a 'member.'").

271. Alberto R. Gonzales & J. Leigh Griffith, *Challenges of Multi-State Series and Framework for Judicial Analysis*, 42 J. CORP. L. 653, 656 (2017).

272. *Id.* at 657.

273. See Mooney, *supra* note 267, at 668.

274. *Id.* ("The LLC, despite its separate series, could be taxable as a single entity for federal income tax purposes.")

275. *Id.* ("[E]ach series could be treated as a disregarded entity, the sole owner of which is the LLC of which it is a part.")

276. Prop. Treas. Reg. § 301.7701-1(a)(5), 75 Fed. Reg. 55,699, 55,707–09 (Sept. 14, 2010).

277. *Id.* § 301.7701-1(a)(5)(i), 75 Fed. Reg. at 55,707.

278. See I.R.C. § 501(c)(3) (2018).

279. Gonzales & Griffith, *supra* note 271, at 656.

charitable assets with particular donors.<sup>280</sup> While technically all of the assets in all of the funds belong to the sponsoring organization, donors have a certain amount of control over the assets in funds associated with them.

It is not a significant stretch to treat each separate account as a separate charitable entity for purposes of classifying the account as a public charity or a private foundation. The classification of an entity for federal tax purposes does not depend on that entity's treatment under state or local law.<sup>281</sup>

If the IRS treated each segregated account as a separate charitable entity, the tax law would not require a third classification for donor-advised funds and would not require an additional set of rules. In most instances, it would look at who was donating to the account under the standard rules that differentiate public charities from private foundations. Essentially, that would implicate two rules: the more-than-one-third rule and the not-more-than-one-third rule.

The more-than-one-third rule requires that a tax-exempt organization be treated as a private foundation unless more than one-third of its support comes from governmental units, public charities, and "persons other than disqualified persons . . . with respect to the organization."<sup>282</sup> Disqualified persons include foundation managers, substantial contributors, and certain individuals and entities related to the foundation managers and substantial contributors.<sup>283</sup>

The foundation manager limitation would be unlikely to do much work with respect to donor-advised funds. The Code defines a foundation manager as an "officer, director, or trustee of a foundation" or an employee of the foundation with authority to act for the foundation.<sup>284</sup> In a donor-advised fund, the equivalent of the foundation manager would most likely be the sponsoring organization, and the sponsoring organization would be unlikely to make many, if any, donations to its funds. The donors generally have the ability to advise the sponsoring organization on investments strategies and where to send money, but they lack any authority to make those things happen.<sup>285</sup> As a result, donor-advised funds are likely to receive little, if any, money from disqualified foundation managers.

The substantial contributor limitation, on the other hand, is likely to ensnare a significant portion of donor-advised funds. The Code defines a substantial contributor as anybody who contributes more than \$5000 to the foundation, as long as that \$5000 is more than

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280. See Colinvaux, *supra* note 99, at 22.

281. Treas. Reg. § 301.7701-1(a)(1) (as amended in 2011).

282. I.R.C. § 509(a)(2)(A).

283. *Id.* § 4946(a)(1).

284. *Id.* § 4946(b).

285. See *supra* notes 101–03 and accompanying text.

2 percent of the contributions received by the foundation.<sup>286</sup> Moreover, “[o]nce a person is a substantial contributor with respect to a private foundation, [s]he remains a substantial contributor.”<sup>287</sup> As long as a donor-advised fund gets the bulk of its donations from a single donor (or that donor and her spouse),<sup>288</sup> it will not qualify as a public charity.

Even in years where the donors make no contributions, a donor-advised fund would find it difficult to qualify as a public charity. Along with the public support requirement, a public charity cannot receive more than one-third of its support in any given year from, among other things, investment income (including interest, dividends, rents, and royalties).<sup>289</sup> As a result, even in a year where the donor makes no contributions (and thus there is no problem with the substantial contributor limitation), most segregated accounts of a donor-advised fund would not qualify as a public charity because more than one-third of their income is likely to be investment income.

Treating segregated accounts of donor-advised funds as separate entities does not mean that no donor-advised fund will ever qualify as a public charity. If, for instance, fifty individuals got together to donate to one segregated account, and they all consistently donated the same amount every year, no individual would be a substantial contributor,<sup>290</sup> and their donor-advised fund would meet the public support test.

This would be a perfectly acceptable result. If a donor-advised fund had fifty contributors, the fund would be accountable to those fifty people. That broad public accountability was exactly what Congress had in mind when it enacted the public support requirement for public charities.<sup>291</sup> Congress believed that that level of public accountability superseded the need for tighter regulation and excise taxes that the private foundation regime imposed.<sup>292</sup>

Keeping the two current classifications of tax-exempt organizations avoids adding complexity to the tax system. It also simplifies future reforms. Congress may decide to adopt one of the reform proposals for donor-advised funds in the future. It is hard to justify requiring a donor-advised fund—but not a private foundation—to pay out all of its receipts within five years or to forbid a donor to a donor-advised fund—but not a private foundation—from taking a charitable deduction until the fund distributes the money to

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286. I.R.C. §§ 507(d)(2)(A), 4946(a)(2).

287. Treas. Reg. § 1.507-6(b)(1) (1972).

288. I.R.C. § 507(d).

289. *Id.* § 509(a)(2)(B)(i), (e).

290. Nobody would be a substantial contributor because each donor would provide exactly 2 percent of the donor-advised fund’s aggregate receipts. Because nobody donated more than 2 percent, nobody would meet the statutory definition of a substantial contributor.

291. *See supra* notes 189–92 and accompanying text.

292. *See supra* notes 191–94 and accompanying text.

an active charity. If Congress determines that one of these reforms—or another type of reform—is valuable, it can simply change the private foundation rules. Because the categorization of donor-advised funds would occur individually for each segregated account, the new rule would automatically take effect for those donor-advised funds too.

#### VIII. CONCLUSION

The ability of donor-advised funds to effectively function as private foundations, while technically qualifying as public charities, makes them remarkably attractive to donors. They simultaneously provide donors with the effective (if not the legal) control of a private foundation and the deduction limitations, privacy, and lack of distribution requirements of a public charity.

By fitting in the gap between public charities and private foundations, donor-advised funds allow donors to circumvent rules Congress has enacted to ensure that tax-deductible donations benefit the public good. While there may be societal benefits to allowing accelerated deductions for money that will go to charitable purposes eventually, there are also downsides. For instance, a charity cannot use money that it does not have, and the government also cannot use revenue that it has foregone.

Perhaps just as important, the ability of the wealthy to take charitable deductions without oversight and without actually donating the money could erode the public's trust.<sup>293</sup> That trust is critical to the viability of the charitable sector.<sup>294</sup> By capturing donor-advised funds that act like private foundations and treating them as private foundations for tax purposes, Congress and the IRS can ensure that they exercise the appropriate level of oversight in regulating donor-advised funds, helping to ensure both the appropriate treatment of charitable donors and continued public confidence in the charitable sector.

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293. See, e.g., Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1, 7 (2009) ("The barrage of media reports on scandals and abuses in the charitable sector, combined with the perception of lax regulation, has eroded public confidence in the charitable sector.").

294. *Id.* at 7–8 ("Public confidence in the sector's integrity is essential to its survival since it relies heavily on gratuitous contributions of cash, property, and services.").