Financial Planning Association of Greater Indiana

Charitable gift Planning with Donor Advised Funds

*Beyond the Basics*

**Presenter**

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**Charitable Gift Planning with Donor Advised Funds—Beyond the Basics**

**I. Donor Advised Fund Fundamentals**

1. **Introduction:** According the *IRS Donor-Advised Funds Guide Sheet* (Internal Revenue Manual 7.20.8, dated August 6, 2008), donor advised funds have been a part of the charitable landscape in the United States “for nearly a century, and have long been a staple of community foundations.” Donor advised funds at community foundations took root just after private foundations begun by the likes of Carnegie, Rockefeller, Ford and Eli Lilly came to prominence in the early to mid-1900s. The first donor advised fund is reported to have been created at the New York Community Trust around 1931—“and the popularity of this charitable giving vehicle has been growing ever since.” Report to Congress on Supporting Organizations and Donor Advised Funds, Department of Treasury (Dec., 2011) (hereinafter "Treasury Report"), p. 21. In the 1990s, in addition to community foundations offering donor advised funds as just one aspect of their work in their respective communities, financial institutions began creating “sister” 501(c)(3) public charities for the sole purpose of housing donor advised funds. In addition, a variety of other religious and national donor advised fund charities, such as the National Philanthropic Trust, have emerged and many colleges and universities now offer donor advised funds, but generally restrict the grant making to university projects or purposes. As explained by the Department of Treasury in the Treasury Report, donor advised funds "have become increasingly relevant in the charitable sector, in terms of both their numbers and their assets." Treasury Report, p.1. A recent Congressional Research Service Report dated July 11, 2012, reports that national commercial donor advised fund sponsors currently control roughly one-third of donor advised fund assets, whereas community foundations account for 43 percent and religious organizations 15 percent.

In its “*2012 Donor Advised Fund Report*,” the National Philanthropic Trust reported that assets in donor advised funds grew by $5.5 billion in 2011, and that assets under management in all donor advised fund accounts totaled $37.43 billion. The total number of donor advised funds in the United States grew by 51.3% from 2005 to 2010. According to a 2012 article in the Chronicle of Philanthropy, donor advised funds are continued to show robust growth in 2012. *“Donor-Advised Funds Show Robust Growth,”* Chronicle of Philanthropy, May 27, 2012. Donor advised funds now outnumber traditional private foundations by more than two to one. *“How To Find The Right Donor-Advised Fund (And Why*),” Forbes, Feb 28, 2011. They also exceed the combined number of charitable remainder trusts, charitable gift annuities and pooled income funds. *Id.* The Bank of America/ IU School of Philanthropy “*2012 Study of High Net Worth Philanthropy,”* reported that 17.1% of wealthy households at that time gave through donor advised funds at a community foundation, financial institution or in another organization.

1. **The Basics**: Generally, donor advised funds allow individuals, families, corporations and other entities to establish a separate charitable account at a host charity, the “sponsoring organization,” with irrevocable gifts of cash, stock or other assets, and take a charitable income tax deduction in the year the account is established (and each year in which additional contributions are made to the fund). A fund agreement or other instrument of transfer is executed. The donor, the donor's family, or other donor advisor or advisory committee appointed by the donor can then recommend to the sponsoring charity qualified charitable recipients to receive grants from the donor advised fund, either right away, over any number of months or years, or forever. Some donor advised funds will be fully expended during the donor’s life time, whereas others are set up as permanent endowment-type funds. Successor advisors such as children and grandchildren may be identified, depending on the policies of the various sponsoring organizations. Subject to sponsoring organization policy, donors may or may not retain the right to advise the sponsoring organization on investment matters. The sponsoring organization must review all grant recommendations to ensure that proposed grants are for a qualified charity or charitable purpose, and generally heeds the recommendations from the donor-- but is not compelled to do so, as it is the legal owner of the assets in the fund.

A donor advised fund represents for many an alternative option to the establishment of a private foundation. Like private foundations, donor advised funds can be created during the donor’s lifetime or through his or her estate plans. Whereas the general rule of thumb for creating a new private foundation is that one should be able to devote at least $1 million and perhaps as much as $5 to $10 million or more to justify the legal time and expense, a donor advised fund can be established for $25,000 at many community foundations and for as little as $5,000 at most of the commercial donor advised funds. Lest one jump to the conclusion that a private foundation is more appropriate for assets of *more* than $10 million, myriad donor advised funds are established with far more than that, including several that have been funded with more than $10 million at Central Indiana Community Foundation. Practical considerations in selecting one charitable vehicle over the other, as well as selecting a particular donor advised sponsoring organization are considered in Section II below.

**C. Pension Protection Act:** With the popularity of donor advised funds, of course, also came abuses and, eventually, Title XII of the Pension Protection Act of 2006 (“PPA). While the PPA enacted certain rules around donor advised funds to ensure against abuses, as a practical matter, it served more importantly as a milestone in further "legitimizing" donor-advised funds. It also provided a first ever statutory definition, and hence more clarity and comfort for advisors in recommending and utilizing this significant charitable tool. According to the Council on Foundations, the number of donor advised funds increased by 15 % in 2007 alone, the year following enactment of the PPA.

**1. PPA Definition of Donor Advised Fund**:The PPA added Internal Revenue Code Section 4966 (d) (2), which provides a three-pronged definition of donor advised fund:

* a fund or account that is separately identified by reference to contributions of a donor or donors,
* is owned and controlled by a “sponsoring organization,” and
* with respect to which the donor, or any person appointed or designated by such donor (“donor advisor”), has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund by reason of the donor’s status as a donor.

The Joint Committee Report, which serves as the legislative history of the PPA, expands upon each of these prongs:

*Separately identified by reference to contributions of a donor or donors*. This prong requires that the sponsoring organization reference the contributions of a donor or donors to the particular fund or account on its books and records by, e.g., naming the fund after the donor or by attributing contributions to a specific donor or donors. Accordingly, a fund of broad, general interest donors generally will not be considered to be a donor-advised fund, even if it has an advisor or advisors, provided the contributions of specific donors are not tracked for attribution purposes.

*Owned or Controlled by a Sponsoring Organization.* A “sponsoring organization” is defined under Section 4966(d)(1)as a Section 170(c)(1) organization that is not a governmental organization or a private foundation and maintains one or more donor advised funds. public charity, other than a supporting organization, that maintains one or more donor-advised funds.

*A Donor or any Person Appointed by the Donor has Advisory Privileges*. The PPA does not define “advisory privileges,” other than to refer to advisory privileges as to distributions or investments. The Joint Committee Report notes that the presence of advisory privileges may be evidenced by a written agreement or through conduct of the donor or donor advisor and the sponsoring organization. The Joint Committee Report also distinguishes between advisory privileges and legal rights or obligations.

**2. Excise Tax on Taxable Distributions.** The PPA also imposed a few of the "private foundation rules" on donor advised funds, including the 20 percent tax on taxable distributions. Pursuant to Code Section 4966(c), distributions from a donor advised fund to an individual are prohibited, as are distributions to any organization that are not for a charitable purpose. Other distributions, e.g., to a private foundation or certain types of supporting organizations, may require the sponsoring organization to exercise expenditure responsibility.

**3. Excise Tax on More -Than -Incidental Benefits.**  Code Section 4967 imposes a penalty tax on a donor advisor who recommends a grant from a donor advised fund that results in more than an incidental benefitbeing received from the grantee by a disqualified person. The definition of “disqualified person” applicable to donor advised funds includes any donor, donor advisor, or member of the family of a donor or donor advisor or a 35% controlled entity of which a donor or donor advisor owns more than 35% of the combined voting power, profits, interests, or beneficial interest. Code Sections 4976(d), 4958(f)(7), and 4958(f)(4). For donor advised fund disqualified person purposes, family members include a spouse, ancestors, lineal descendants (down to great-grandchildren), and siblings (whether whole or half), as well as their spouses. In addition to prohibited benefits from grantees back to donor advisors and other disqualified persons, the PPA also introduced the “excess benefits transactions” rule to donor advised funds. An excess benefit transaction for donor advised fund purposes is one in which a disqualified person receives an economic benefit, directly or indirectly, that exceeds the value of the services provided to the charity. This is more liberal that the flat out prohibition applicable to private foundations.

**4. Excess Business Holdings Rules:** The PPA also extended the private foundation excess business holdings rules to donor advised funds. In general, if a donor advised fund receives a gift or bequest of an interest in a business enterprise, it has 5 years to divest itself of any excess holdings, with a possibility of an additional 5 years under limited circumstances if approved by the Secretary of the Treasury. The holdings of a donor advised fund in a business enterprise, aggregated with the holdings of disqualified persons with respect to the fund, will be subject to penalties on the excess holdings if the aggregate holdings exceed: (1) 20 percent of the voting stock in a business enterprise in corporate form (35 percent if persons who are not disqualified persons have effective control of the business); (2) 20 percent of the profit interest in a partnership; or (3) 20 percent of the beneficial interest of a trust or estate. Code Section 4943. A *de minimus* exception applies when a donor advised fund, together with its disqualified persons (as defined in Code Section 4943), owns not more than 2 percent of the voting stock of a business enterprise. Code Section 4943 (c)(2)(C). "Business enterprise" is defined as the active conduct of a trade or business and does not include a business that derives at least 95percent of its income from passive sources such as dividends, interest, royalties and capital gains. Interests in family limited partnerships generally will come under this exclusion.

**5. Department of Treasury Report:** Section 1226(a) of the PPA mandated that the Department of Treasury conduct a study on the organization and operation of both supporting organizations (as distinguished from donor advised fund sponsoring organizations) and donor advised funds. PPA Section 1226(b) mandated that the Secretary of the Treasury submit a report on the supporting organization and donor advised study to Congress. That report, the Treasury Report, *infra*, was submitted to Congress on December 5, 2011. As respects DAFs, Treasury was directed by the PPA to specifically consider:

1. Whether the existing deduction rules for contributions to donor advised funds are appropriate (Treasury answer: yes);

2. Whether donor advised funds should be subject to a distribution requirement like private foundations (Treasury answer: no); and

3. Whether an advisory role in the investment or distribution of donated funds is consistent with a completed gift and consequent qualification for a deduction from income, gift and estate tax purposes (Treasury answer: yes)

No new legislative changes or reforms are recommended by the Department of Treasury in the 109-page Report. Among other findings, the Treasury found:

* The fact that donor advised funds have high approval rates for donor recommendations is not in itself indicative of donors' exerting excessive control over their donated assets. Approval is not automatic.
* The PPA appears to have provided a legal structure to address abusive practices and accommodate innovations in the sector without creating undue additional burden or new opportunities for abuse.
* The issue of the lag between contribution and final use of assets is no different at donor advised fund sponsoring organizations than it is for other public charities that may operate charitable funds or maintain endowments. "Thus, it is appropriate that the contribution deduction rules faced by donors to donor advised funds are the same as those applicable to donors to other public charities." Treasury Report at 7.
* It would be premature to recommend a distribution requirement for donor advised funds at this point. As more years of data become available, analysis of trends with respect to donor advised fund distributions will be possible.
* As is the case with gifts to other charities, if all existing tax and other legal requirements are met, donations to a donor advised fund may be completed gifts and become the property of the donee organization. Although donee organizations may feel an obligation to use donated funds in a manner preferred by the donor, especially when subsequent contributions may be desired, "there is nothing unique about donor advised funds... in this regard and, in fact, they have no legal obligation to follow the preference of the donor." *Id.* at 9.

Senator Grassley was not satisfied with the Treasury Report, as reported in the unpublished Congressional Research Service Report on Donor Advised Funds, dated July 11, 2012 (CRS Report), p.1. The CRS Report takes issue with several findings of the Treasury Report, including the Treasury finding that the average payout rate for donor advised funds in 2006 was 9.3 percent of assets. CRS also concluded that donors have effective control over donor advised fund grantmaking, as contrasted with the Treasury Department's conclusion that legal control of donor advised fund assets is vested in the sponsoring organization's board of directors, and that approval of grant recommendations from fund advisors is not automatic. When a congressman or congressional committee does not agree with the conclusions of the appropriate federal agency in a statutorily mandated report, what is the effect of an unpublished Congressional Research Service "rebuttal" prepared by a Specialist in Public Finance and a Senior Specialist in Economic Policy? Suffice it to say that sponsoring organizations will need to be vigilant in assuring that donor advised fund assets are not being squandered and that fund advisors are not in control of donor advised fund assets.

**D. Outlier Cases:** Two recent cases indicate the need to do one's homework in advance of making an irrevocable donation to a sponsoring organization to establish a donor advised fund. In 2009, the Federal Bankruptcy Court for the Eastern District of Virginia approved a reorganization plan for the National Heritage Foundation which wiped out donor advised funds at the foundation totaling $25 million. The dollars in the donor advised funds were determined to be assets of the bankruptcy estate and were used in part to make a lump sum payment to 107 people with charitable gift annuities. Although National Heritage Foundation described itself as "the gold standard of donor advised funds" on its website, it had apparently had a long history of run-ins with the IRS and with practices that eventually were outlawed by the PPA. See, "*Charity Bankruptcy Leaves Many Donors in Distress"*, New York Times**,** Nov. 12, 2009.

Another cautionary tale points to the necessity for the donor to conduct due diligence not only on the sponsoring charity, but also on the charitable tax planning advisor--especially, perhaps, if the advisor recommends a particular charity established by the advisor. In *Styles V. Friends of Fiji,* No. 51642 (Nev. 2011), the Nevada Supreme Court, in an unpublished opinion, upheld a Nevada district court ruling that although a sponsoring organization "failed to attempt in any way" to satisfy its donor's charitable goals and breached its implied covenant of good faith and fair dealings, the donor, Mr. Styles, suffered no legal damages because "once he made the unrestricted gifts into his fund, he no longer had any interest or control over the donation." Although charitable experts agree that the Court correctly rejected Styles' argument that he was entitled to a return of the donation (for which he had taken an income tax charitable deduction), they disagree as to the absence of equitable remedies in connection with the breach of the charity's duty of good faith. The underlying fund or gift agreement provisions were not discussed, but what happened with Mr. Style's fund assets is genuinely unfathomable in the community foundation world, in which fulfilling donor intent underlies all that we do.

According to an article written by esteemed charitable gift planning lawyer Richard L. Fox, who was tangentially involved in the case, the facts underlying the *Styles* case are unbelievable. See, http://www.quatloos.com/2009/03/ray-styles-v-friends-of-fiji-big-winner.html. Mr. Styles, from Wichita Falls, won $8 million at a slot machine in Lake Tahoe. The tax planning "expert" he turned to in his abundance steered him to Friends of Fiji to make a $2.5 million contribution to establish a donor advised fund. The advisor had created the charity and served as an officer and director. Mr. Styles’ contribution was the only contribution ever made to Friends of Fiji, which of course is long since defunct. The only two (one being the advisor) officers and directors of the charity ignored Mr. Styles' recommended distributions, including one that the entire balance of his donor advised fund be distributed to the Nevada Community Foundation. The Friends of Fiji used the donor advised fund assets instead to create another organization to assist with a charitable cause of interest to its board and to pay outlandish annual compensation to the officers of that organization, who were the same officers of Friends of Fiji. Monies from the fund also were used for celebrity golf tournaments. Following the 2004 filing of his initial lawsuit with the assistance of local Las Vegas counsel, Mr. Styles engaged Richard Fox to serve as an advisor and personal lawyer in 2006. Mr. Fox makes clear in the article that he had "no involvement in any of the planning stages that occurred" prior to the filing of the case. Further, "given the prohibitive costs" involved in pursuing the appeal, Mr. Styles filed a pro se appeal --with the unpaid assistance of Mr. Fox. (Thankfully, per notation at the top of the opinion and pursuant to Nevada Supreme Court Rule 123, unpublished orders "shall not be regarded as precedent and shall not be cited as legal authority.")

**II. Considerations in Choosing to Establish a Donor Advised Fund**

**A. Questions for the Client Who Wants a Private Foundation:**

1. What are the charitable purposes of the foundation? I.e., does the donor have a clue what to support, an idea of charitable mission, ideas about how to accomplish the purposes?

2. What is the level of personal financial commitment to the foundation?

3. Will the anticipated foundation assets justify the expense of establishing and operating the foundation?

4. Who will serve on the board of directors? Indiana nonprofit law requires at least three.

5. What kind of time commitment will the founder and individual board members give to the foundation business? Will the foundation hire staff or will volunteers manage all operations?

6. Will there be family interested in continuing the foundation when the original donor or donors are deceased?

**B. Benefits of a Donor Advised Fund:** Some advantages of donor advised funds over private foundations and other charitable giving vehicles include:

* **Simplicity***.* Donor advised funds have no start-up costs. The sponsoring organization already exists, so setting up a fund is easy, whereas establishing a new private foundation, supporting organization or charitable trust is both time consuming and expensive.
* **Elimination of Administrative Hassles**. Donor advised funds are not required to file IRS Form 990s. The sponsoring organization handles all record keeping and ensures compliance with regulatory requirements.
* **Flexibility***.* The donor may support multiple charitable organizations with one fund--and one asset, if desired.
* **Experience and Service**. Depending on the sponsoring organization, the donor obtains the services, knowledge and expertise of a professional grants and philanthropic services staff for a comparatively low fee (often one percent or less of the fund balance.) With community foundation sponsoring organizations, the research and knowledge of the community foundation is shared with donor advised fund donors, and the foundation can assist with identifying and fulfilling the donor’s personal charitable goals, researching specific charities, facilitating site visits, etc.
* **Available Ongoing Philanthropic Planning**. Most community foundation sponsoring organizations, including CICF, offer strategic charitable planning and family philanthropy facilitation.
* **Minimal Expense/Required Investment**. The minimum amount required to start a donor advised fund is much less than the minimum amount recommended to establish other charitable vehicles such as a private foundation, supporting organization or charitable trust
* **Ability to "Take a Test Drive**.**”** Most sponsoring organizations offer pass through donor advised funds (whereas the more traditional endowment type funds are available less frequently). Thus, a donor could open a donor advised pass through fund for the minimum required amount with the assurance that the donor could recommend grants from the fund out to charities of the donor's choice and spend out the entire amount of the fund. For donors concerned about whether the ability to serve as fund advisors to their fund provides them sufficient input over the distribution of their charitable capital, the pass-through alternative could provide a great introduction to charitable giving through donor advised funds. It also could be a great introduction and learning experience prior to the establishment of a private foundation.
* **Immediate Tax Deductibility**. Donor advised funds are especially attractive for donors with sudden and/or one time increases in income. The amount donated to establish a donor advised fund is tax deductible for the year the transfer to the fund is received from the donor, even though the donor may need additional time to recommend or advise grants to be made from the fund. The availability of an immediate income tax deduction without first having to determine all of the charitable recipients can prove very helpful to donors.
* **Greater Tax Deductibility**. Gifts to establish donor advised funds constitute gifts to public charities and are deductible up to 50% or 30% of adjusted gross income (for cash and publically traded securities, respectively), as opposed to the 30% or 20% limit for gifts to private foundations. Donors also can deduct the full fair market value of appreciated long-term capital gain property contributed to a donor advised fund—whereas the deduction for inter-vivos gifts of long-term, non- marketable assets to private foundations generally is limited to cost basis.
* **Anonymity if Desirable***.* Donors have the opportunity to give anonymously, which is nearly impossible with private foundation reporting requirements. The entire fund can be anonymous or certain grants made from the fund can be anonymous.
* **Recognition if Desirable**. The donor can choose to name the donor advised fund after the donor or the donor’s family and call it a family foundation with associated name recognition and prestige. The donor also could establish a fund as a memorial to honor someone.
* **Legacy***.* Through donor advised funds, donors can build lasting legacies to their families and the causes or charitable organizations they support. Depending on fund size, most donor advised funds allow for successor generations to continue to advise the fund.
* **No Excise Tax on Earnings**. Earnings from donor advised fund assets can be devoted to charitable causes of the donor’s choosing, rather than the government’s (through the investment earnings excise tax applicable to private foundations.)
* **No Required Payout*.*** Donors can choose to not grant every year and have the opportunity to build up their endowment fund over time if desirable.
* **Centralized and Streamlined Charitable Giving**. Donors can make a single charitable contribution, take the tax deduction for that one gift, and make distributions from the fund at a later time to myriad charities without the need on the part of the donor to keep track of multiple charitable substantiation letters and tax years.
* **Protection from Solicitation**. The sponsoring organization receives all mail on behalf of the fund. Donors’ addresses and other contact information remains protected. Depending on the sponsoring organizations policies, donors can refer all requests for funding to the sponsoring organization and thus avoid having to respond affirmatively or negatively themselves to specific requests.
* **Corporate Foundation Ease**. For corporations considering private foundations, donor advised funds offer ‘turn-key” operation with no or minimal additional staff time required. All investment, compliance, administration, check distribution, etc., can be handled by the sponsoring organization in the name of the corporation, e.g., the ABC Corporation Foundation, thus freeing up staff to focus on the business of the corporation.

**C. Using Donor Advised Funds with Private Foundations:** Many times the most appropriate vehicle to meet a client’s charitable objectives is not an either/or, but a both/and. There are many situations in which private foundations could benefit from the establishment of a companion donor advised fund to more effectively accomplish the donor’s objectives. Examples of utilizing both vehicles for more effective giving include:

* **Meeting the Required Five Percent Distribution Requirement.** Donor advised funds offer private foundations greater flexibility in grant payout management. Through a grant from a private foundation to a donor advised fund, the private foundation can obtain additional time to meet its annual five percent payout requirement. Time might simply have gotten away from the private foundation board or family, they may be waiting on a potential grantee to obtain requisite charitable status or accomplish certain objectives or conditions precedent to intended funding, or they may want to open a donor advised fund in order to strategically accumulate rather than pay out charitable assets for a certain period of time.
* **Making Anonymous Grants.** All of the information included in a private foundation’s IRS Form 990-PF is readily available online, including asset base, the names and contact information of the officers and directors, and grants paid by grantee organization and amount. Donor advised funds, on the other hand, can keep donor names and grants completely confidential. Thus, a private foundation could establish a donor advised fund to make potentially controversial grants or to expand its interest area without opening up the foundation to additional stacks of grant requests from other nonprofits serving the new interest area.
* **Utilizing Donor Advised Funds as Recipients of Charitable Lead Trusts.** From an estate planning perspective, private foundations often do not work well as the charitable recipient of income from charitable lead trusts. A similar, but much simpler approach for grantors of charitable lead trusts would be to establish a donor advised fund to be the recipient of the charitable lead interest. This also is an easy method to essentially benefit multiple charitable organizations through one trust, as discussed in more detail in Section III. A. 3.
* **Obtaining Enhanced Tax Benefits.** As public charities, sponsoring organizations’ more favorable income tax deduction limitations often are more attractive than those afforded to donors of charitable gifts to private foundations. A donor may wish to ensure more charitable assets are available from a particular asset by donating it to a donor advised fund sponsoring organization, even though the donor also has a private foundation, due to income tax deductibility factors.
* **Disclaiming to a donor advised fund rather than a private foundation.** A problem arises if a parent names a child as a beneficiary of an estate and through the child's disclaimer the property passes to a private foundation where the child is a director. The child's participation in the private foundation's selection of charitable grant recipients could prevent the disclaimer from being a “qualified disclaimer,” because the child's involvement in selecting the recipients to receive grants from the disclaimed property could violate the requirement for a qualified disclaimer that the property pass "without any direction on the part of the person making the disclaimer". Code Section 2581; Treas. Reg. Sec.25.2518-2(d)(1) and (2); 25.2518-2(e)(1)(I).  
    
  Although one solution for the private foundation would be for it to amend its bylaws so as to prohibit the child and child's spouse from participating in the selection of grant recipients from the disclaimed property, with the disclaimed assets being isolated from other foundation assets in a separate account, this is a cumbersome and clumsy solution that interferes with the parent's intention to involve the child in the work of the foundation. (PLRs approving/upholding disclaimer with similar facts: 200802010 (Sept. 12, 2007), 200744005 (June 28, 2007), 200649123 (Aug. 23 2006), 200616026 (Dec. 22, 2005), 2004420007 (Jan. 23, 2004), 9317039 (Feb. 2 1993) and 9141017 (July 10, 1991)).  
    
  A better solution might be to have a child disclaim property to a donor advised fund at a community foundation. The IRS concluded that the advisory nature of a child's or grandchild's grant recommendations did not pose a problem. PLRs 200518012 (Dec. 17, 2004 (disclaimers by grandchildren) and 9532027 (May 12, 1995)( disclaimers by children). (This recommendation is from the presentation materials prepared by Christopher Hoyt, *“Charitable Giving Implications of the 2012-2013 Income and Estate Tax Environment and Gifts and Bequests of Retirement Assets,*” Council on Foundations Advanced Legal Seminar, Sept. 9, 2012 (“Hoyt Presentation”)).

1. **Choosing a Donor Advised Fund Sponsoring Organization:** The “outlier cases” serve as ample warning: not all donor advised “programs” and sponsoring organizations are the same! Some issues to consider in determining whether a donor advised fund at a particular sponsoring organization will suit a donor’s current and future needs include:

1. What assets may be contributed to the fund? (More than cash and publically traded securities? Real estate? Business interests? Tangible personal property?)

2. Are there geographical or interest area limitations on grantmaking? (CICF and affiliated community foundations do not impose geographical restrictions—grants from donor advised funds may be made to any U.S. 501(c)(3) public charity.)

3. Services beyond the basics? (Will the sponsoring organization host advisory committee meetings, perform research on interest areas or specific charitable organizations, assist with mission or purpose statement development, goal setting and impact assessment?)

4. Online access?

5. Investment choices? (By law, the sponsoring organization has ultimate authority and control over the investment of donor advised fund assets and must establish investment policies concerning the fund. But can the donor recommend a certain investment manager be hired by the sponsoring organization for his or her fund? Commercial sponsors generally limit investments to their mutual fund offerings. CICF allows a donor to recommend an outside investment manager if the fund assets are $500,000 or greater.)

6. Investment performance—even if outside investment manager selection recommendations are allowed, it might make more sense to let the sponsoring organization invest the assets of the fund.

6. What is the sponsoring organization’s policy regarding successor advisors and multi-generational involvement in the fund?

7. What is the financial picture and reputation of the sponsoring organization? Are there references who can be contacted regarding their experience with the organization? What is the amount of unrestricted assets versus liabilities of the organization? What is its history?

8. What are the fund minimums? Will an “acorn fund” be allowed?

9. What are the fees, and what will the fees cover? E.g., consider the difference between funds that come with a local philanthropic advisor and family philanthropy education and involvement versus a 1-800 number.

**III. Creative or “Advanced” uses for Donor Advised Funds**

**A. Use a Donor Advised Fund as the Charitable Recipient When Drafting Defined Value Formula Clauses.** Consider an estate plan in which an individual states in his or her will and trust instruments: "Give to my family the federal estate tax threshold in the year that I die, e.g., $5.25 million, and give the rest to charity." The intent is to avoid estate tax, and although this is not difficult when the estate or trust consists of liquid assets with undisputable valuations, a potential problem arises there if there are illiquid assets with a wide potential range of values e.g., real estate, limited liability company, partnership interests, etc. A defined value clause can be very helpful for such situations.

Three recent cases have upheld the use of defined value formula clauses (also referred to as “charitable lids”) to reduce or eliminate estate or gift tax liability that might be imposed as a result of IRS audits changing the valuation of the transferred assets from the value that originally was reported on the estate or gift tax returns:

*Estate of Petter V. Commissioner,* 653 F.3rd 1012 (9th Cir. 2011) affirming T.C. Memo. 2009-280 (Dec. 7, 2009) (gift tax);

*Estate of Christiansen v. Commissioner,* 586 F. 3rd 1061 (8th Cir. 2009), affirming 130 T.C. 1 (2008) (estate tax); and

*Hendrix v. Commissioner,* T.C. Memo. 2011-133 (June 15, 2011) (gift tax).

In each case, the clauses allocated the entire increased valuation amounts to charity so that the increased charitable tax deduction eliminated any increased estate or gift tax liability as a result of an increased valuation. The "formula allocation clauses" utilized in these cases differed from "savings clauses" that have been found to be void in previous cases (e.g., *Commissioner v. Procter,* 142 F. 2nd 824 (4th Cir. 1944). The savings clause approach required the recipient to return to the donor whatever portion of the gifted property was subsequently valued higher than the original valuation. Whereas the savings clauses operated to change the amount of the completed gift, the formula allocation clauses only change the allocation among the various recipients.

In his January 2012 article in Trusts & Estates, *The Perfect Storm*, Charles Redd urged that "now's the optimum time to provide charitably inclined clients holding difficult-to-value property with the opportunity to make gifts and sales of such property--allocating a stated dollar amount in value of the property to or in trust for their descendants, and allocating the remainder to charity." Redd counsels that before too long the IRS is likely to promulgate a regulation to eviscerate this excellent technique --which it was expressly invited to do by 9th Circuit Court of Appeals in *Petter*, *supra,* in response to the IRS complaining that defined value formula clauses remove any financial incentive for the IRS to audit an estate or gift tax return.

**1. Drafting language:** In *Petter*, the niece of the founder of United Parcel Service (“UPS”) put UPS stock in a limited partnership and, among other complex gift and estate plans, made inter vivos gifts of the partnership units through two long-term trusts to her two adult children and two donor advised funds at the children’s respective community foundations, the Seattle Foundation and the Kitsap Community Foundation. The relevant sections from the *Petter* gift documents, as set forth in the 9th Circuit’s opinion, provide:

1.1 Subject to the terms and conditions of this Agreement, Transferor:

1.1.1. assigns to the Trust as a gift the number of Units described in Recital C above that equals one-half the <maximum> dollar amount that can pass free of federal gift tax by reason of Transferor’s applicable exclusion amount allowed by Code Section 2010(c). Transferor currently understands her unused applicable exclusion amount to be $907,820, so that the amount of the gift should be $453,910; and

1.1.2. assigns to The Seattle Foundation as a gift <to the A. Y. Petter Family Advised Fund of The Seattle Foundation > the difference between the total number of Units described in Recital C above and the number of Units assigned to the Trust in Section 1.1.1.

1.2 The Trust agrees that, if the value of the Units it initially receives is finally determined for federal gift tax purposes to exceed the amount described in Section 1.1.1, Trustee will, on behalf of the Trust and as a condition of the gift to it, transfer the excess Units to The Seattle Foundation as soon as practicable.

1.3 The Seattle Foundation agrees that, if the value of the Units the Trust initially receives is finally determined for federal gift tax purposes to be less that the amount described in Section 1.1.1, the Seattle Foundation will, as a condition of the gift to it, transfer the excess Units to the Trust as soon as practicable.

The fair value of the membership units as of the transfer date in 2002 was determined by a qualified appraiser to be $536.20 per unit. Following IRS audit in 2005 of the 2002 gift tax return, the parties settled the valuation issue stipulating to a $744.74 value per unit at the time of transfer. As a result of the stipulated value and the reallocation clauses of the transfer agreements, the community foundation donor advised funds received additional units from the adult children. The tax court allowed the taxpayer (Mrs. Petter) to amend her 2002 gift tax return to take an additional charitable deduction based on the value of the additional LLC units the community foundation donor advised funds received.

**2. Practical tips for selecting and planning for a charitable recipient.** As a result of the reallocation approved in *Petter*, the Seattle Foundation received over $3.3 million worth of *additional* partnership units into the donor advised fund advised by the daughter of Mrs. Petter. This amount is likely more than many charitable organizations would be able to handle and more than most donors would intend to give to any single charity.A donor advised fund would be a great choice of public charity in such cases because it would allow for future grants to more than just one charity.

Whereas donor advised funds were used as the charitable recipients in *Petter* and *Hendrix.* (See also, *McCord v. Commissioner,* 461 F. 3rd 614 (5th Cir. 2006), also using a donor advised fund), a private foundation was used as the charitable recipient in *Christiansen, supra.*  With both private foundations and donor advised funds, it is important to “plan an exit strategy” for the business interest donated to the charity due to the excess business holdings rules discussed above. Private foundations are subject to harsher self-dealing tax if the property is sold to a disqualified person, which is often a desired part of the plan. A private foundation’s sale of an asset to a donor or to a related family member will likely trigger the tax. Section 4941 (d)(2)(F). Donor advised funds, on the other hand, are only subject to the usual rule that property must be sold for a reasonable price. There is no self-dealing penalty for a sale transaction with a donor advised fund. Nor would there be problems with a potential failure to meet the private foundation 5 percent distribution requirement that could be imposed retroactively to the date of gift (which was several years earlier in *Petter*).

**B.** **Use a Donor Advised Fund to Accelerate Donations or "Pre-fund" Charitable Giving into Desired Tax Year.** As the income tax charitable deduction continues under fire, it may make sense to accelerate charitable donations planned or hoped for future years into 2013 while the charitable income tax deduction treatment is most favorable. A donor advised fund could offer your clients the opportunity to “have their cake and eat it too,” meaning that they can act this year to lock in the deduction for charitable gifts this year to a donor advised fund that they can then grant out from the fund in future years. A donor advised fund allows for the decoupling of the timing of the charitable contribution that provides the deduction and when the actual donations (grants from the fund) are made to specific charities. This year, leaving aside the possible effect of the Pease limitation, we know that your clients can deduct up to 50% of their adjusted gross income (AGI) for cash contributions and 30% of AGI for donating securities. The deduction for the current year is allowable for contributions to a donor advised fund even if the actual grants to charitable organizations are not made until well into the future.

If it makes financial sense to do so, a donor can open a donor advised fund quickly at year-end as his or her financial situation is better known and perhaps a slightly better picture emerges concerning the fate of the federal income tax charitable deduction. The same logic applies for clients with larger income tax events in one particular year. A donor advised fund will allow the desired increased income tax deduction in the year of the income event, but allow for the smoothing out of charitable contributions.

1. **Use a Donor Advised Fund to Accept Complicated or Unusual Assets (while simultaneously avoiding capital gains tax):** The American Tax Relief Act of 2012 (ATRA) substantially increased the top capital gains tax rate. First, the basic tax was increased from 15 to 20% for taxpayers in the new top income tax bracket. Next, since capital gains are included in adjusted gross income, capital gains realization also would generate additional tax liability through ATRA’s modified reinstatement of the Pease limitation—resulting in a top rate of 21.2%. Finally, although not a result of ATRA, the 3.8% Medicare investment surcharge beginning in 2013 results in increasing the highest marginal rate on capital gains to 25%. A higher capital gains tax rate increases the incentive to donate appreciated property. Not only does the donor get a charitable deduction (in most cases) for the current fair value of the gift, but also avoids paying capital gains tax on the unrealized gain. Needless to say, charitable gifts of appreciated property are now more attractive than ever.

Although cash and appreciated, publically traded securities are the most common assets utilized to make charitable gifts, including establishing donor advised funds, it might make sense for a particular donor to consider a donation of a more complicated asset, such as privately held business interests, especially if the donation occurs in connection with the sale of the business and a substantial income (and consequent income tax) event to the donor. When illiquid business interests, or other long-term capital gain interests such as real estate, are donated to a *public charity* (as distinguished here importantly from a private foundation) in the optimal manner, the donor eliminates potential capital gain on the donated portion and generally is entitled to the full fair market value for charitable income tax deduction purposes. However, even if a public charity is sophisticated enough to accept such a complex asset, the donor may rather split that gifted asset among several charities—which is difficult if not impossible to do through the donation of one asset—unless that asset is donated to a donor advised fund. By utilizing a donor advised fund at sponsoring organization that accepts complicated assets (and which can be trusted to accept such gifts, such as the community foundation), the donor is able to benefit myriad charitable recipients through one gift and only one charity to work with in connection with the transfer.

**D. Use a Donor Advised Fund as the Charitable Recipient of CLTs, CRTs and CGAs**

**To Take Advantage of Low Applicable Federal Rates or To Maximize Flexibility.** Although rates are on the rise, we still are in the midst of historically low applicable federal rates. This is good news for the use of gift vehicles that benefit from lower interest rates, such as charitable lead trusts and charitable gift annuities. With the applicable federal rate for Section 7520 at a record low 1 percent not long ago, a charitable lead annuity trust (CLAT) making fixed payments to charity of just 5.3 percent for 21 years resulted in a 100 percent gift tax charitable deduction. Sharpe, R.F., Jr., *“The Philanthropic ‘Meltdown,*’” Trusts & Estates (Sept. 2012). A donor advised fund is a very flexible charitable recipient for a donor setting up a CLAT, since the donor can then recommend grants from the fund to a variety of charitable organizations, or can name family members to serve as the advisory committee of the fund.

Charitable remainder trusts and charitable gift annuities funded with appreciated, low-yield stock or other assets also might be attractive in the current low interest rate/ low AFR environment. Sharpe offers the example of a 75 year-old donor who funds a charitable remainder annuity trust paying 5 percent for life, using $1 million of appreciated stock that had been paying dividends of less than 1 percent. The donor would bypass capital gains tax at the time of the gift and increase the donor’s income from less than $10,000 to $50,000 annually—much of which will be taxed at lower than ordinary income tax rates—while at the same time generating a current charitable income tax deduction of $496,000. The donor could establish a donor advised fund to receive the remainder interest and allow his or her children to serve as advisors or specify various charitable organizations to receive distributions from the fund either permanently, as endowment funds, or in one time lump sum payments…or over whatever time period the donor specifies in the fund agreement setting up the future donor advised fund. Similar to the idea of prefunding future charitable donations into donor advised funds, the donor in the above CRT scenario might also want to fund such a gift before December 31 while favorable charitable income tax deduction treatment is known.

Finally, designating a donor advised fund as the remainderman of a CRT maximizes the flexibility and eliminates the need to ever change the remainder charity designation since the donor advised fund can make grants (upon donor recommendation and sponsoring organization approval) to any 501(c)(3) public charity).

**E. Convert IRA Assets to a "Philanthropic Inheritance" through a Donor Advised Fund:**  Retirement plan assets constitute the largest asset holding of many Americans. These assets do not pass via will or trust, but rather through beneficiary designation on the beneficial form of the Plan Custodian. Beneficiary designations are revocable until death, can be made and changed easily and can be split between individuals and charity, or among charities. Retirement plan assets left to individuals are heavily taxed and consequently “expensive” to inherit. Therefore, retirement plan assets are great assets to donate to charity.

According to the January 7, 2012 edition of Gift Law, there will be a dramatic increase in the number of individuals who choose to leave IRAs to charity or to testamentary unitrusts. IRA beneficiary designations could potentially affect the transfer of several trillion dollars of assets in pension plans. Donor advised funds can be the beneficiary of an IRA or qualified pension plan. The decedent’s children can then have the assets applied toward charitable purposes that are important to them—relieving the children from using their own income or assets to make charitable contributions meaningful to them. A large donor advised fund (or private foundation) can increase the children’s prestige as a significant contributor in the community, a sort of “philanthropic inheritance.” Future funds provide a way to leave a “philanthropic inheritance” which is a shift from the traditional “it’s yours to spend freely” to “it’s yours to support charity” for some share of the family wealth.

**F. Don’t Forget the Obvious—Using a Donor Advised Fund to Receive a Bequest. This too can be a "beyond the basics" proposition!** Bequests are the most common and primary source of planned giving revenue. Testamentary gifts will be more likely than major outright gifts from the baby boomer generation due to uncertainty about social security, rising health care costs, and lack of retirement savings. Bequests are the MAJOR gift of the Middle Class. There is a tendency of even the wealthy to defer gifts of assets until death during more volatile economic times—based on a study going back to 1931. When the net worth of people shrinks, they are less likely to give substantial amounts in their lifetime. The relative importance of bequests is greater in uncertain times when people are feeling less secure.

Donor advised funds likely are most commonly thought of in connection with formalizing a donor's "giving while living." One school of thought is, "why leave the fun of charitable giving to someone else after you've gone"? However, myriad charitably inclined donors choose to create or add to donor advised funds through their estate plan--for myriad reasons. Perhaps they plan to donate a complicated asset that they need the use or enjoyment of during their lifetime. (In this case, advise your client to notify the sponsoring organization to ensure the organization will accept the asset.) Perhaps they have a private foundation during their life, but they decide to plan for a post mortem donor advised fund to receive the assets of the private foundation in order to ensure their intent is carried forward or to ease the burden on future generations. Many donor advised fund sponsoring organizations provide extensive philanthropic services, so a donor could decide that a donor advised fund is a better match going forward with the successor generations being hosted and administered by the sponsoring organization. One of our donor stories included in the next section, provides an intricate case study on detailed planning for ensuring post mortem donor intent.

A bequest of art work, collections, jewelry, coins or other tangible personal property could be a wonderful way in which to leave a charitable legacy or “philanthropic inheritance” while simultaneously relieving your clients’ heirs of the worry about how to effectively and fairly dispose of the meaningful item or items. The "related use" requirement does not apply to charitable estate gifts, so the estate will be able to deduct the full fair market value of the bequest. Beware of the possible need, however, for qualified appraisals in order to claim charitable tax deductions for contributions of noncash property valued at more than $5,000. Code Section 170(f)(11) (C).

1. **Transfer a Private Foundation to a Donor Advised Fund:** An increasing number of private foundations have been terminated in recent years. *“Key Facts on Family Foundations,”* (The Foundation Center, 2008), http://foundationcenter.org/gainknowledge//research/pdf/keyfacts\_fam\_2008.pdf. According to a 2010, article in the Journal of Accountancy, the precipitous drop in wealth in the U.S. during the 2008-2009 financial melt-down accelerated a trend of many private foundations’ considering closing their doors. McCallister, B., “*Closing Up Shop: How to Successfully Shut Down a Private Foundation,”* Journal of Accountancy, July, 2010. Because of the increased interest in private foundation termination, the IRS issued Publication 4779, *Facts about Terminating or Merging Your Exempt Organization*, in May, 2009.Private foundation termination can happen by choice for any number of reasons. Private foundations can become a burden. They can be time consuming and expensive. Filing requirements and tax rules are complicated. Family members may differ as to grantmaking priorities. Decisions about who should run the foundation, details of the grantmaking process, etc., may be more work than initially anticipated. In volatile economic times, the amount of money available for grantmaking based on asset base and investment income can be reduced perhaps to the point where it does not make sense for the private foundation to continue as an independent entity.

Many individuals, families and corporations head down the private foundation path without any awareness of simpler, less costly, turn-key alternatives available through community foundations. According to IRS statistical data, nearly 66% of private foundations filing returns for tax year 2005 had assets of $1 million of less. Table 1, Domestic Private Foundations: “Number and Selected Financial Data, by Type of Foundation and Size of End-of-Year Fair Market Value of Total Assets, Tax year End 2005,” Tax Stats, [www.irs.gov](http://www.irs.gov). However, running a $1 million (or less) private foundation could prove more difficult to the donor than running a $10 or $100 million private foundation because the smaller foundation cannot afford to hire staff. If the asset base has been reduced or was never sufficiently large to begin with, or if managing the private foundation becomes too burdensome for whatever reason, it may make sense to consider transferring the private foundation assets to a donor advised fund.

The board of the private foundation can choose to continue on in a very similar capacity as the advisory committee of the donor advised fund to recommend charitable uses of the private foundation-turned donor advised fund assets. Code Section 507 (b) (1) (A) permits the termination of a private foundation in either corporate or trust form and a distribution of its assets to a public charity, provided the charity has been in existence for five years preceding the distribution. Community foundations quite frequently accept the transfer of private foundation assets into a donor advised fund. No advance IRS approval or notice is necessary. Pursuant to IC 23-17-22-1 *et seq*., dissolution is straightforward and relatively simple. No court or attorney general approval is required.

**IV. Donor Advised Fund Case Studies**

In helping to figure out how to accomplish your clients’ and our donors’ charitable goals, we have gathered as many unique donor stories as we have donors, and have learned that there are nearly as many different motivations and inspirations for establishing a donor advised fund as there are tools and techniques that have enabled our donors to establish them. A few such motivations, techniques and tools that are a bit “beyond the basics” (and which our donors have given us permission to discuss), include:

**A. Business Interest**

1. Donor about to sell interest in privately held race track/casino.

2. Prior to any sales agreement, donor transferred a portion of his business interest to Legacy Fund.

3. When business was sold, Legacy Fund’s portion of the business was liquidated and donor advised fund received the proceeds.

4. Tax savings on gifting the business interest prior to sale of business. Advance charitable planning is key.

**B. Appreciated Assets—beyond the basics**

1. Water front lot on a reservoir. Donor had held for investment and grew tired of paying property taxes. Donated real estate to Legacy Fund donor advised fund. Legacy Fund will sell and add proceeds from sale to donor’s fund. Even before final sale, donor will get 2012 charitable income tax deduction on the appraised market value of the property—and avoid all capital gain on the transfer of the property.

2. In 2000 (before the American Jobs Creation Act of 2004), a Patek Phillipe “repeater” watch from the early 20th century. Watch was donor’s father’s and was donated by her to CICF to fund a family endowed donor advised fund. The watch was sold by Sotheby’s at auction for nearly $1 million. The fund awarded more than $145,000 in grants to educational and faith based programs before the family members decided to split it into four individual donor advised funds overseen by the children and their families. Four families and a grandmother actively engaged in philanthropy thanks to a watch.

**C. Corporate Foundation Alternative**

1. RND Group, Inc., liked the “turn-key” approach to using a combination of two donor advised funds, a pass through donor advised fund, which receives a percentage of RND’s quarterly earnings, and an endowment donor advised fund, which receives a permanent grant from the RND pass through fund annually and which will exist in perpetuity to ensure RND’s generous legacy.

2. CICF organizes the annual meetings of RND’s leadership and helps them recommend grants from the pass through fund based on agreed upon mission and goals they develop with the assistance of CICF staff. We do all the research and administration. The leadership team comes together efficiently to accomplish the charitable purposes of the company—without taking valuable time away from the business.

**D. Estate Planning Tool**

1. One donor couple, a sincere desire to “give back,” two charitable trusts, a charitable gift annuity and a donor advised fund.

*Charitable gift annuity* - used to create fixed income stream for a friend and her disabled son, with the residuum of CGA to fund a designated fund established by the couple to benefit Noble of Indiana, which had provided care for the son.

*Donor advised fund* - used to provide assistance to educational, cultural and social services organizations. The fund will be advised by several generations.

*Charitable lead annuity trust*- distributions fund the donor advised fund. Trust assets will be returned to donors and their children upon termination of trust.

*Charitable remainder unitrust* - provides income to donors and family and remainder will go to donor advised fund.

2. Clearly articulated intent and instructions.

(i) *Future fund* that was a combination “donor designated fund” and “field of interest endowment fund”, (similar to donor advised funds, but slightly different community foundation fund types) with fund agreement drafted with donor, his estate planning lawyer and CICF.

(ii) Fund was funded on the second to die with gifts from couple’s estate, the remainder from two charitable trusts and the assets of the private family foundation that the couple utilized during their lifetimes, but which was terminated upon death and distributed to CICF fund.

(iii) Per detailed instructions in the fund agreement and a side letter, the fund makes annual payments of 60 percent of annual earnings to four named local organizations in varying percentages specified in the fund agreement. The remaining 40 percent of annual earnings is used for grants in charitable fields of interest to the donors (specified in the fund agreement): arts organizations, libraries, environmental conservation, and health. The side letter provides instruction as to the names and types of organizations supported by the donors in these areas during their lifetimes, which provides guidance to the CICF Board in determining recipients of distributions from the field of interest portion of the fund.

**Disclaimer:** This information is based upon our continuing analysis of the relevant legislation and regulations. While we make every effort to ensure accuracy, this information is not a substitute for expert legal, tax, or other professional advice and may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.