Whether distributions made by private foundations to donor-advised funds should be treated as “qualifying distributions” for purposes of the 5% annual payout rule is a significant issue in the world of philanthropy.

There is a big unresolved public policy issue in the philanthropic world—private foundations and their use of donor-advised funds (DAFs). Specifically, the issue is whether distributions made by private foundations to donor-advised funds should be treated as “qualifying distributions” for purposes of the 5% annual payout rule.

While the issue was sparsely debated before, the IRS really stirred the debate in the charitable world with the issuance of Notice 2017-73. The Notice specifically requests comments on whether a contribution to a DAF by a private foundation should be considered a distribution that counts as a “qualifying distribution” for the purposes of the annual 5% payout rule. Comments in response to the Notice poured in, and opinions were deeply divided between those in favor of reform to disallow or limit “qualifying distributions” to DAFs and those in full defense of the IRS maintaining the status quo.

Two years have passed since the issuance of the Notice, and the IRS has yet to issue any regulations or proposed regulations. This article highlights some of the major arguments for reform, limits, and the status quo regarding private foundations’ distributions to DAFs “counting” as qualified distributions.

Background
In the planning techniques available for charitable vehicles, private foundations and donor-advised funds are tools frequently used by donors. Both have distinct advantages and disadvantages.

Private foundations. A private foundation is a unique Section 501(c)(3) tax-exempt organization in that it provides the donor with ultimate legal control. Private foundations allow the donor ultimate control over: the structure of the foundation; the selection of the board of directors, trustees, and employees; the day-to-day operations; and the investments and distributions. In exchange for this control, Congress created strict rules and regulations to help ensure private foundations operate as intended—to distribute income for charitable purposes. Two of the main rules and regulations private foundations are subject to are the payout rules and the disclosure rules.
Private foundations and donor-advised funds (DAFs) are tools frequently used by donors, and both have distinct advantages and disadvantages

Similarly, since the government provides generous tax benefits to private foundations, they are subjected to extensive disclosure requirements to ensure that their distributions are utilized for a charitable purpose. Private foundations are required to make information about the private foundation, like the type of assets held, names and contact information of the officers, and the name of the donee along with the amount of money distributed to that donee, available to the public via their tax filing, Form 990-PF. Congress’ intent behind this regulation was not only to ensure that private foundations’ distributions are utilized for charitable purposes but also to provide the general public with transparent access to the finances and donation activities of the private foundation.

DAFs. On the other hand, DAFs, due to the “public” nature of their structure, are not subject to the payout and disclosure rules private foundations face. With DAFs, a donor creates an account with a sponsoring organization—an already registered 501(c)(3) public charity, and contributes cash, stock, or other assets. The donor cedes full legal control of the assets but can take an immediate tax deduction for the gift to the account at the time of contribution. The account is controlled by the sponsoring organization (usually a community foundation or a nonprofit affiliate of a financial services company like Vanguard Charitable or Schwab Charitable), which invests the assets and manages the donor’s account. Once the fund is up and running, the donor or another designated advisor then advises the sponsoring organization which charities they would like to donate to from their accounts and when they would like to donate.

The structure of a DAF is like a personal charitable checking account. Important to this structure, though, is that the donor only retains the right to advise the sponsoring organization on distributions because he or she ceded full legal control of the assets to the sponsoring organization at the time of contribution. Public charities are not subject to the same payout and disclosure requirements as private foundations; therefore, because a DAF is technically controlled by a public charity—the sponsoring organization—it does not have to abide by strict payout and disclosure requirements like private foundations do.

Given the unique advantages of both private foundations and DAFs, it is not surprising that donors consider the use of both charitable vehicles in tandem. For instance, a private foundation can make a distribution to a DAF established by the private foundation at a sponsoring organization to satisfy its 5% annual payout requirement.

It is now common for private foundations to establish DAFs to receive and meet their required annual minimum distribution. In fact, Elon Musk’s foundation made a distribution of $37.8 million in 2016 to Vanguard Charitable to establish a DAF to meet the foundation’s required annual minimum distribution. The Economist, through a random sampling of private foundations, found that more than 90% of private foundation distributions went to DAFs.

It is a win-win for the donor, because the distribution counts for purposes of the foundation’s payout requirement (because the DAF sponsor is a public charity), and even after distribution to the DAF the foundation can still advise the sponsoring organization on which charities it would like to donate to from its account and when. However, enter the big public policy issue—should this really be allowed? Are private foundation distributions to DAFs really a “qualified distribution” for purposes of the payout? Can a donor have his cake and eat it too?

Notice 2017-73

This is exactly what the IRS asked on 12/4/17 in Notice 2017-73, requesting comments on whether a contribution to a DAF by a private foundation should be considered a distribution that counts as a “qualifying distribution” only if the DAF sponsoring organization agrees to distribute the funds within a certain timeframe. Though not expressed in the Notice, the IRS’s concern is that private foundations are using DAFs to sidestep the private foundation payout requirements. The purpose of the
private foundation payout requirement is to guarantee that private foundation funds are disbursed for actual charitable purposes. A private foundation can totally sidestep the whole purpose of the requirement if it makes a distribution to a DAF and the DAF does not distribute the funds (which currently they are not required to do). Whether they like it or not, the IRS stirred up a big public policy debate among those in the charitable world when they requested comments on this issue. Notice response letters and commentary came flowing in from the ABA Section of Taxation, the Council on Foundations, Fidelity Charitable, and the New York Bar Association Tax Section, to name a few, and the responses have been deeply divided.

In one camp are the critics who have devoted their careers to DAF reform and are in favor of the IRS disallowing or limiting private foundation qualifying distributions to DAFs. Their opinions are strong—for example, take critic Ed Kleinbard, a tax professor at the University of Southern California. He called the ability of private foundations to utilize DAFs “a fraud on the American taxpayer,” and “a way for the affluent to have their cake and eat it, too.” At the heart of their argument is the notion that allowing private foundation to DAF transfers to count as qualifying distributions for payout purposes is contrary to the intent behind the private foundation payout rules and disclosure rules.

On the opposite side are equally opinionated advocates of the IRS maintaining the status quo and continuing to allow for qualifying distributions from private foundations to DAFs. The advocates, namely Community Foundations like the Council On Foundations, an association with some 1,600 members, or proponents of such, have a real stake in any charitable giving reform and have urged the IRS not to implement any rules that restrict private foundations’ ability to use DAFs as it will hinder charitable giving and “tie the hands of donors.” As one advocate so aptly wrote the IRS, “don’t clip the wings of (or even chisel away at) the golden goose.”

Payout rules
Two of the biggest critics, law professors and DAF experts, Ray Madoff and Roger Colinvaux, in their notice response letter to the Senate Finance Committee, argue that allowing private foundation to DAF transfers to count as qualifying distributions for payout purposes is contrary to the intent behind the private foundation payout rules. They argue that the Congressional intent behind the private foundation payout rules was to ensure that private foundation funds distributions are an actual benefit to the public and distributed to charities in a timely manner. However, when funds are distributed to DAFs because DAFs have no payout requirements, there is no guarantee that the funds will actually benefit the public in a timely manner, if at all.

In fact, funds could sit in a donor-advised fund for generations and never benefit the public. This directly violates the intent of the payout rules, critics say, because the donor gets the tax benefit of the charitable deduction, but the funds have not gone to an actual charitable purpose, but simply moved from one charitable fund to another fund that has no requirement for the money to ever get to a charitable recipient.

Two of the main rules and regulations private foundations are subject to are the payout rules and the disclosure rules.

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3. See Section 4942.
4. See Section 4942.
7. See Section 6104.
8. See Section 4966(d)(1). (The section was enacted as part of the Pension Protection Act of 2006 and provides a definition for DAFs, as well as defines the organization holding the donor-advised fund as a “sponsoring organization.”)
15. Ibid.
18. See Madoff and Colinvaux, letter to the Honorable Orrin Hatch, Chairman, Committee on Finance, United States Senate, 7/17/17.
20. See Motulsky, letter to the IRS, 2/21/18.
21. See Madoff and Colinvaux, letter to the Honorable Orrin Hatch, Chairman, Committee on Finance, United States Senate, 7/17/17.
DAFs are not subject to the payout and disclosure rules private foundations face. Among the Silicon Valley tech giants, other tech titans, such as Sergey Brin, co-founder of Google, Jack Dorsey, co-founder of Twitter, and Nicholas Woodman, founder of GoPro, have also utilized their private foundations to make distributions to the Silicon Valley Community Foundation’s DAF, a fund popular among the Silicon Valley tech giants. Other tech titans, such as Sergey Brin, co-founder of Google, Jack Dorsey, co-founder of Twitter, and Nicholas Woodman, founder of GoPro, have also utilized their private foundations to make distributions to the Silicon Valley Community Foundation’s DAF. While within the letter of the law, these CEO and co-founders can allow their money to sit in the DAF indefinitely, allowing account managers to rack up earning fees, yet they get the immediate tax deduction when distributed to the DAF.

This has to stop, critics argue, as this type of behavior is not consistent with the spirit of the payout rules that have governed private foundations since 1969. In order to address these concerns, critics on the extreme side of DAF reform are responding to Congress, urging them to provide rules that foundation to DAF transfers are not “qualifying distributions” for purposes of a private foundation’s payout. Others are recommending that Congress require a payout rule for DAFs to ensure funds from DAFs are distributed to charities. Cantor has suggested a 15-year payout period for DAFs, while Madoff and Colinvaux have recommended 10 years, and a proposal submitted to Congress by former U.S. Rep. Dave Camp recommended five years. Either way critics all agree that as the law stands private foundation to DAF transfers are contrary to the intent of the payout rules and Congress needs to respond to ensure private foundations are fulfilling their charitable purpose.

But payouts happen

Advocates of the IRS maintaining the status quo and continuing to allow for qualifying distributions from private foundations to DAFs note that while DAFs may not have payout requirements, funds are still benefiting the public and getting into the hands of charities in a timely manner. For example, Schwab Charitable Fund contends that on average their DAFs distribute 20% a year, and The National Philanthropic Trust reports a similar 20% payout average with their latest report showing an all-time high of 22.1% in 2017. This is well above the 5% private foundation payout requirement. When payout is already this high, advocates have a tough time understanding why added “redundant” payout rules are necessary when the funds in DAFs are being paid out to charities.

While critics argue funds will just sit in DAFs given the built-in incentive for fee income and asset appreciation, advocates are not too concerned about this because they note that there is a bigger built-in incentive not to let funds sit—DAFs must pass Section 509(a)’s “public support” test in order to retain their status as a public charity. A DAF sponsor can lose its public charity status if the income generated from assets are unequal to the contributions to the DAF. Therefore, if sponsoring organizations of DAFs are just allowing the assets to sit and the contributions to pile as critics suggest, they would jeopardize their public charity status, which certainly would not be a welcomed outcome.

Moreover, advocates argue that even though funds from private foundation to DAF transfers are getting into the hands of charities in a timely manner, many DAFs have implemented further safeguards to ensure this. For instance, Schwab Charitable and Vanguard Charitable both have “minimum-grant activity requirements” that require donors to make annual gifts from their accounts in an amount that exceeds a 5% five-year average of the account’s assets. If the donor does not meet...
this requirement. Schwab Charitable or Vanguard Charitable can make distributions on the donor’s behalf.\textsuperscript{40} Community-sponsored DAFs have similar safeguards as well. The Council of Michigan Foundations notes in its notice response letter that many community foundations adhere to the National Standards for U.S. Community Foundations, which includes an inactive DAF policy that assures that no fund goes for more than two years without distributing funds to a charity.\textsuperscript{41}

Despite the safeguard, funds hardly ever stay in DAFs for more than two years, because as advocate Rose Meissner, president of the Community Foundation of St. Joseph County, notes in her response letter, only in rare occasions are funds allowed to sit in a DAF, the main exception being private foundations and DAFs which are working with charities on specific targeted goals.\textsuperscript{42} Instead of distributing its 5% payout requirement directly to the public charity, the private foundation can make a distribution to a DAF sponsor of the charity and then recommend DAF distributions to the public charity as certain projects are completed and/or milestones are met. If Congress were to eliminate private foundation “qualifying distributions” to DAFs, donors would lose this crucial benefit to hold the charity accountable to targeted goals.

Lastly, even if there is a slight delay in DAF distributions to public charities, advocates argue that the slight delay does not violate the spirit of the payout rule as critics suggest but allows for more thoughtful and conscience gift-making. For instance, as Joanne Kelly, CEO of Colorado Association of Funders, writes in her notice response, if a private foundation gets to the end of the year and has not fully met its 5% payout requirement, rather than distributing the funds haphazardly to a public charity to meet the requirement, the private foundation can contribute to a DAF. This allows the private foundation a bit more time to make knowledgeable and careful decisions regarding its gift-making.\textsuperscript{43}

Daniel Hemel, assistant professor of tax at the University of Chicago Law School, does not see this as a “bad thing.” He writes “…if the alternative is that you rush your decision and give this year to a charity that might not make the best use of the funds, then DAFs don’t seem so terrible from a public policy perspective.”\textsuperscript{44} “Is this having your cake and eating it too? Well, it’s really more like refrigerating your slice of cake and giving it away later,” noted Hemel.\textsuperscript{45}

\textsuperscript{22} Ibid.
\textsuperscript{24} Ibid.
\textsuperscript{25} Ibid.
\textsuperscript{26} See Cantor, “Donor-Advised Funds and the Shifting Charitable Landscape: Why Congress Must Respond,” 133 (unpublished manuscript).
\textsuperscript{28} See Cantor, “Donor-Advised Funds and the Shifting Charitable Landscape: Why Congress Must Respond.”
\textsuperscript{31} See Butler, “Meet Ray Madsen, the Woman Saving the World from Philanthropy,” The Daily Dose, 5/4/15.
\textsuperscript{32} See Madsen and Colinvaux, letter to the Honorable Orrin Hatch, Chairman, Committee on Finance, United States Senate, 7/17/17.
\textsuperscript{34} See “Annual Giving Report 2015,” Schwab Charitable, 2015; see also Eisenberg, “There’s A Target On Charity’s Booming Donor-Advised Funds,” Forbes, 8/2/18 (noting that Schwab Charitable and Fidelity allege that 80% and 84% of the donor’s funds, respectfully, are fully paid out to charities within 10 years. Fidelity even further alleges that 74% is fully paid out to charities within five years.).
\textsuperscript{37} See Hemel, “Who’s Afraid of Donor Advised Funds?”, Medium, 8/14/18.
\textsuperscript{38} See Hemel, “Who’s Afraid of Donor Advised Funds?,” Medium, 8/14/18.
\textsuperscript{39} Ibid.
\textsuperscript{40} Ibid.
\textsuperscript{42} See Community Foundation of St. Joseph County, letter to the IRS, 3/5/18.
\textsuperscript{43} See Colorado Association of Funders, letter to the IRS, 3/5/18 (Kelly further notes that “those community foundations who from time to time do hold a small number of DAFs for private or family foundations report that these funds are typically spent within a very short period given the high demand for funding.”).
\textsuperscript{44} See Hemel, “Who’s Afraid of Donor Advised Funds?,” Medium, 8/14/18 (Hemel argues “if the alternative is that you don’t make the gift and don’t claim the tax deduction, then DAFs deprive the U.S. Treasury of some revenue but also reduce the amount that goes to charity.”).
\textsuperscript{45} See Hemel, “Who’s Afraid of Donor Advised Funds?,” Medium, 8/14/18.
Critics, on the other hand, note that "these are the donors that most need a push to distribute funds to charity and who, for whatever reason, are indecisive." "The ability to use a DAF may be a benefit to the indecisive donor, but the law should not tolerate unlimited indecision. The point of the DAF is to distribute the money to a charity that can use it" and thus payout rules for DAFs are necessary.\(^46\)

Payouts increase giving

Advocates of maintaining the status quo do not believe that private foundations make distributions to DAFs just to avoid their payout requirements as critics suggest.\(^47\) They emphasize that the ability of private foundations to transfer to DAFs is a valuable tool for private foundations that actually encourages giving due to the multiple benefits DAFs can provide, all of which are consistent with the spirit of the law.\(^48\) Their concern is if Congress were to implement rules that would restrict a private foundation’s ability to use DAFs to meet its payout requirement, "even if the intent is only to target perceived abuse, the end result will be to hamper several activities that fulfill a genuine charitable purpose."\(^49\)

One benefit of private foundations utilizing DAFs that advocates attribute to increased giving is their ability for collaborative gift giving. Multiple foundations can contribute to a DAF to pool resources and jointly support a project or area of interest.\(^50\) The DAF provides a "vehicle that can accept and manage contributions from multiple sources without the need for establishing an additional management structure for the collaboration," touts Deborah L. Wilkerson, president and CEO of the Greater Kansas City Community Foundation in her notice response.\(^51\)

Additionally, advocates note that private foundation to DAF transfers increase giving and can fulfill a genuine charitable purpose because they allow donors to make gifts outside their normal area of giving. Many private foundations have a specific area of focus but giving to a DAF allows donors a bit of flexibility if they want to donate to a different cause outside of their focus. Not only does this help "address other critical needs,"\(^52\) but "it avoids sending a signal to other charities that might encourage them to request similar support."\(^53\)

Further, donors may shy away from giving if they lack the intimate knowledge of a specific area or lack the resources. While large private foundations like the Bill & Melinda Gates Foundation or the Ford Foundation have the staff resources and legal knowhow to manage gifts and see to it that they are making the greatest impact, many small family private foundations do not have this luxury.\(^54\) Enter the DAF. A private foundation can make a distribution to a community foundation DAF which "allows it to access the local knowledge and experience of the community foundation’s staff and their familiarity with potential grantees," notes Sean Parnell, an independent consultant for The Philanthropy Roundtable and Roundtable’s former vice president of public policy.\(^55\) Overall, advocates claim that the ability of private foundations to use DAFs as a qualifying distribution has only increased giving based on their many benefits and has made gifts possible in specific project areas or communities that would not see the same kind of funding if private foundations were not able to do such, which certainly does not violate the spirit of the payout rules.\(^56\)

For these reasons—payout already occurs on a timely manner, there are multiple safeguards requiring such timely payouts, and a slight delay allows for more thoughtful and knowledgeable gift-making—advocates urge Congress that "there should not be a time period imposed on the DAF for making a distribution of the funds received from a private foundation," as critics may suggest.\(^57\)

Disclosure

As mentioned, critics also argue that allowing private foundation to DAF transfers to count for qualifying distributions for payout purposes is contrary to the intent behind the private foundation disclosure rules. Since the government provides generous tax benefits to private foundations, they are subjected to extensive disclosure requirements to ensure that their distributions are utilized for a charitable purpose.\(^58\) Private foundations are required to disclose the names of contributors on their annual return along with the names of the public charity donees and the amounts given to the donees.\(^59\)

With DAFs, on the other hand, the sponsoring organization (like Fidelity or the Silicon Valley Community Foundation) reports publicly that it

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take the donor-advised fund “DonorsTrust,” whose prominent donors, including Charles Koch, have been known to hide their foundation gifting from disclosure, which a report from the Center for Public Integrity details. Its website, DonorsTrust explicitly advertises its ability to provide anonymity to its donors. These prominent donors make large contributions from their private foundations to DonorsTrust and then DonorsTrust anonymously gifts the money “to controversial organizations such as the Heartland Institute, which works to debunk climate change research, and the American Legislative Exchange Council, which writes and facilitates conservative legislation at the state level,” notes Cantor.

If private foundations have nothing to hide, one would think they would tout their donations through their website to show what valuable causes they focus on and contribute to, even those that went through a DAF intermediary, but that is hardly the case critics note. Take the Jill and Nicholas Woodman Foundation. Nicholas Woodman, the founder and CEO of GoPro, donated $500 million worth of shares to his private foundation and then made distributions to a DAF sponsored by the Silicon Valley Community Foundation. Curiously, critic and finance journalist David Gelles, who conducted an

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48 Ibid.
49 See Community Foundation Public Awareness Initiative (CFPAI), letter to the IRS, 3/5/18.
50 See Greater Kansas City Community Foundation, letter to the IRS, 3/2/18.
51 Ibid.
52 See Community Foundation Public Awareness Initiative (CFPAI), letter to the IRS, 3/5/18.
54 See Community Foundation Public Awareness Initiative (CFPAI), letter to the IRS, 3/5/18, see also Council on Foundations, letter to the IRS, 3/5/18.
56 See Allegan County Community Foundation, letter to the IRS, 3/5/18 (further noting “(t)his change in control from the private foundation to a public charity should be considered a positive move, not a cause for concern.”).
57 See Allegan County Community Foundation, letter to the IRS, 3/5/18.
59 See generally Section 6104.
60 See Section 6104(d)(3).
65 Ibid.
66 See Madoff and Colinvaux, letter to the Honorable Orrin Hatch, Chairman, Committee on Finance, United States Senate, 7/17/17.
In one camp are the critics who have devoted their careers to DAF reform and are in favor of the IRS disallowing or limiting private foundation qualifying distributions to DAFs. Critics also note that while we hear through Twitter just about everything going on in Elon Musk’s life, the same cannot be said for his private foundation. In 2016, Musk’s private foundation made a $37.8 million distribution to Vanguard Charitable to establish a DAF. Where these funds have gone or will go is anyone’s guess, as his private foundation’s website offers no clues. The entire website is one paragraph long and lists five broad focus areas. It is hardly a model for transparency, critics note.

Therefore, “it is time for Congress to stop allowing [DAFs] to make a mockery of our charity oversight rules,” says Madoff, and “(i)f purportedly charitable organizations want to benefit from generous tax breaks, we deserve to know who’s really funding them.”

Proponents of the status quo are not too concerned with these particular claims from critics because they do not see the lack of transparency provided by DAFs being abused by private foundation owners. There are legitimate reasons why anonymity is needed. For instance, private foundations can utilize a DAF to make a one-time contribution outside their normal interests. The anonymity provided by the DAF allows them to make a much-needed gift to a charity outside their focus without “opening up a Pandora’s Box” for similar requests from nonprofits outside their norm. Additionally, sometimes for assorted reasons, donors may not want their children, other relatives, friends, or neighbors to know about their philanthropy, or that they have “that much money to give away.”

Anonymity is also necessary for some private foundations for security reasons. One letter response noted that a private foundation utilized a DAF to support an overseas charity that was the target of violence. The use of the DAF shielded the private foundation’s name from being associated with the contribution and provided a sense of security to the private foundation. To advocates, utilizing private foundation to DAF distributions for contributions outside donors’ normal interests and for security is hardly an abuse of DAF anonymity; further, if donors want to hide their gifts from the public there is already a way to do such.

Hemel argues that there is no real need for private foundations to hide their gifts behind DAF go-betweens because individuals can already donate directly to public charities without the public knowing. Public charities do not have to provide the name of contributors. The only reason donors may choose this route is if their funds are already in a private foundation and they decide they want to make a discreet gift to a public charity. “In other words, it’s a backdoor way to support politically connected charities without disclosure when the front door is already wide open,” notes Hemel.

Conclusion; going forward

There is no doubt that the IRS has stirred debate in the philanthropic sector. Critics urge Congress to disallow or limit private foundation transfers to DAFs as they are contrary to the intent of the private foundation payout and disclosure rules, while advocates are in favor of maintaining the status quo as they urge Congress not to implement any rules that would diminish the ability of foundations to use DAFs in furtherance of their legitimate philanthropic purposes. Both critics and advocates alike make valid arguments in support of these claims, so it is not surprising that it has been two years since the IRS requested comments on the public policy issue and no regulatory changes have been proposed.

Going forward, it will certainly be interesting to see what approach Congress takes. Estate planners and donors alike should be prepared for this sector of the philanthropic world to change. However, for now, private foundations can make qualified distributions to DAFs without limitations.