

GAO

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

July 2006

TAX-EXEMPT ORGANIZATIONS

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





Highlights of [GAO-06-799](#), a report to the Chairman, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

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

What GAO Recommends

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

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

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

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

TAX-EXEMPT ORGANIZATIONS

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

What GAO Found

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

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

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

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United States Government Accountability Office
Washington, DC 20548

July 27, 2006

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

Dear Mr. Chairman:

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

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

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

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

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

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

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

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

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

Results in Brief

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

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

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

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

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

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

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

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

Background

IRC section 501(c) specifies 28 types of entities that are eligible for tax-exempt status and over 1.6 million entities have been recognized as exempt as of 2005. One subset of these tax-exempt entities is classified as

⁸A taxpayer identification number (TIN) is generally a Social Security number for individuals or employer identification number for organizations.

501(c)(3) charitable organizations, of which slightly over 1 million existed in 2005, according to IRS. In 1969, Congress directed that all 501(c)(3) organizations would be private foundations unless they qualify for exclusion from that status under IRC section 509. This change subdivided section 501(c)(3) organizations into two general categories—“public charities” and “private foundations.”

Within the public charities classification, Congress created supporting organizations, which are defined in section 509(a)(3) as public charities organized to support one or more public charities, including churches and certain governmental units, and certain other tax-exempt entities, such as membership-based organizations (e.g., unions and professional organizations). Supporting organizations are classified as public charities not because they are themselves publicly supported, but because they are to support another public charity with which they are to maintain a strong relationship. In creating supporting organizations, Congress recognized that it can be beneficial and prudent to place certain assets or activities in a separate legal entity to insulate assets from liability or to facilitate separation of functions for programmatic, accounting, or other reasons, according to the *Panel on the Nonprofit Sector Final Report*.⁹

Donor-advised funds are generally separate accounts operated by tax-exempt public charities to receive contributions from a single donor or group of donors. Donors can advise on the distributions from the account. For the contribution to qualify as a completed gift, the charity must have ultimate control over how the assets in the account are invested and distributed. According to our interviews with knowledgeable individuals and recent Senate testimony, donor-advised funds have generally been in existence since the 1930s and have traditionally been operated by community foundations.¹⁰ In the 1990s, financial investment firms began establishing “commercial funds,” which are tax-exempt public charities that operate donor-advised fund accounts. Investment of contributions to the fund accounts is controlled by the commercial fund’s board, which

⁹The *Panel on the Nonprofit Sector Final Report* was published in June 2005 and contains recommendations for charitable reform. We discuss the Panel Report further in the Background section of this report.

¹⁰Community foundations are charitable organizations established to hold funds contributed from a variety of sources and to use those funds to make charitable grants for the benefit of the local community. See also U.S. Senate, Committee on Finance, statement of Jane G. Gravelle, *Charities and Charitable Giving: Proposals for Reform*, 109th Cong., 1st session, April 5, 2005.

hires the investment firm that established the commercial fund to manage the fund's assets.

Generally, an entity must apply to IRS to obtain tax-exempt recognition. Most organizations seeking recognition from federal income tax must use specific forms, including Form 1023 (Application for Recognition of Exemption under Section 501(c)(3) of the IRC) or Form 1024 (Application for Recognition of Exemption under Section 501(a)) as well as other documentation.¹¹ After receiving tax-exempt recognition, public charitable entities must annually file a Form 990 information return to report their financial transactions and activities for a tax year. Charities that have less than \$100,000 in gross receipts and \$250,000 in year-end assets may use Form 990-EZ. Entities with gross receipts below \$25,000, and certain types of entities, such as churches and certain entities associated with churches, generally are not required to file. Form 990 collects information on revenues, expenses, and assets, and has accompanying schedules. Schedule A of Form 990 covers several areas such as compensation, lobbying expenditures, and revenue sources. Schedule B covers the source of contributions to charities and certain other exempt entities.¹² Congress has granted public access to Form 990 data in recognition of the importance of public oversight to inform donors about how their money is spent and to stem potential abuses. Private foundations, regardless of their amounts of gross receipts or assets, are required file a Form 990-PF information return annually.

IRS oversight of tax-exempt entities generally relies on two activities. First, IRS reviews applications for tax-exempt status to determine whether a tax-exempt purpose is envisioned. IRS approves those applications that are properly completed and for which the applicant can demonstrate to the satisfaction of IRS that its activities or proposed activities meet the requirements of the section under which exemption is claimed. Second, IRS annually examines selected Forms 990 to determine whether the exempt entities meet various requirements (such as properly reporting

¹¹Entities that are not required to apply include those that are not private foundations and that have gross receipts normally not more than \$5,000, as well as churches and certain entities associated with churches. The other documentation to be submitted includes organizing and enabling documents, such as the Articles of Incorporation, financial data and budgets, and a full description of its exempt purposes and activities.

¹²In this report, when we refer to Form 990, we are also referring to Form 990-related schedules, such as Schedules A and B.

unrelated business income tax).¹³ In general, IRS attempts to select entities that it believes are likely to have violated requirements. Based on examination evidence, IRS can accept the Form 990 as filed or change the status of the entity, impose excise taxes for certain types of violations, or revoke the exempt status if the violations are serious enough.¹⁴ As appropriate, IRS can also assess other types of taxes, such as employment taxes or unrelated business income taxes.

In 2004, the Senate Committee on Finance asked a panel of experts to make recommendations to Congress to improve oversight, transparency, and governance in the tax-exempt sector. To do so, the Independent Sector¹⁵ convened a Panel on the Nonprofit Sector in October 2004, which included 24 nonprofit and philanthropic leaders.¹⁶ The Panel issued a final report in June 2005 with over 120 recommendations, several focusing on donor-advised funds and supporting organizations. On the basis of this report and other information, Congress has considered proposals to impose more restrictions and requirements on donor-advised funds and supporting organizations to better ensure that their contributions advance charitable rather than private interests and that their donors do not exert control or receive private benefits. Provisions in legislative proposals that apply to donor-advised funds have included providing a formal definition of a fund, setting minimum payout requirements, and placing restrictions on dealings with those who may privately benefit from charitable activities. Provisions related to supporting organizations have included those that would apply certain private foundation rules and restrictions, such as those on the annual payout requirement and excess business holding rules.

¹³Tax-exempt organizations are required to file a Form 990-T federal tax return and pay taxes on income of \$1,000 or more earned from activities unrelated to their exempt purposes.

¹⁴GAO, *Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*, [GAO-02-526](#) (Washington, D.C.: Apr. 30, 2002) discusses IRS examinations of tax-exempt organizations and reasons for tax-exempt status revocation.

¹⁵The Independent Sector is a national coalition of nonprofit organizations, private foundations, and corporate-giving programs that is to support the tax-exempt sector.

¹⁶The Panel is assisted by over 100 executives of nonprofit entities and other experts on five work groups.

Scope and Methodology

To compare the federal laws and regulations on donor-advised funds and supporting organizations with those for private foundations, we reviewed the IRC, Treasury regulations, IRS publications, and various other documents describing these laws and regulations. We also interviewed 18 IRS staff and 16 individuals knowledgeable about the tax-exempt community, such as attorneys and governmental-affairs managers at tax-exempt entities, to obtain their input about these laws and regulations and our comparison of them.

To determine financial and organizational characteristics of donor-advised funds, supporting organizations, and other tax-exempt charitable organizations, we obtained and analyzed IRS Form 990 and Form 990-PF data, as well as reviewed survey data on donor-advised funds that were collected by *The Chronicle of Philanthropy*. We used the surveys to obtain data on donor-advised funds because this information was not identifiable on the Form 990. To determine the reliability of the donor-advised fund data, we interviewed *The Chronicle of Philanthropy* staff about their survey methodology. To obtain supporting organization and other tax-exempt charitable organization data fields, we obtained data from IRS's Returns Inventory and Classification System (RICS) for tax years 1999 through 2003, the 5 most recent years of data available at the time of our analysis. Because not all the data fields we wanted were available from RICS, we obtained additional Form 990 data fields from GuideStar, an organization that electronically captures Form 990 data for public access. To assess the reliability of the RICS and GuideStar data, we interviewed agency officials and conducted electronic data testing. In addition, we reviewed a selection of Forms 990 submitted to IRS to confirm that the values on the form matched those in the database. While we identified some minor discrepancies, we determined that the Form 990 data were sufficiently reliable for our purposes. The data files we obtained included the population of tax-exempt charities filing returns for those years, including supporting organizations and private foundations. Using computer software to analyze these data files, we determined summary statistics and converted dollar amounts to 2005 constant dollars. For our discussion on "payout" rate, compensation, and Form 990 revisions, we performed literature searches and interviewed 20 knowledgeable individuals from IRS's Statistics of Income (SOI) program and Tax-Exempt

& Government Entities (TE/GE) division, Urban Institute, and Congressional Research Service (CRS).¹⁷

To describe the types of noncompliance and promotion methods involving donor-advised funds and supporting organizations, we reviewed IRS summaries of examination cases. To obtain anecdotal information about noncompliance involving donor-advised funds and supporting organizations, we also interviewed 4 managers at IRS who oversee examinations of donor-advised funds and supporting organizations and 7 individuals knowledgeable about the tax-exempt community who work at organizations such as the Council on Foundations and the Independent Sector. We also interviewed 6 financial professionals and 11 community foundation managers on how donor-advised funds and supporting organizations are promoted to clients for abusive transactions. We also reviewed an IRS research report on developing abusive promoter leads through searching the Internet.

To provide additional information on noncash contribution valuation methods (see app. III), we reviewed IRS publications and forms and interviewed an IRS field specialist working on valuation issues in the Large and Mid-Sized Business operating division. To obtain information on the marketing of donor-advised funds and supporting organizations (see app. IV), we spoke with 11 community foundation managers, 6 financial professionals, and 18 managers at IRS. The examples we discuss come from materials that we were referred to or located online based on our interviews, and do not necessarily represent all materials and methods used to market donor-advised funds and supporting organizations.

¹⁷IRS's SOI program collects and processes tax data and annually publishes statistics related to the tax system. IRS's TE/GE division covers the areas of employee plans, exempt organizations, and government entities. The Urban Institute is a nonpartisan public policy research center that operates the National Center for Charitable Statistics. CRS is the public policy research arm of Congress.

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

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

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

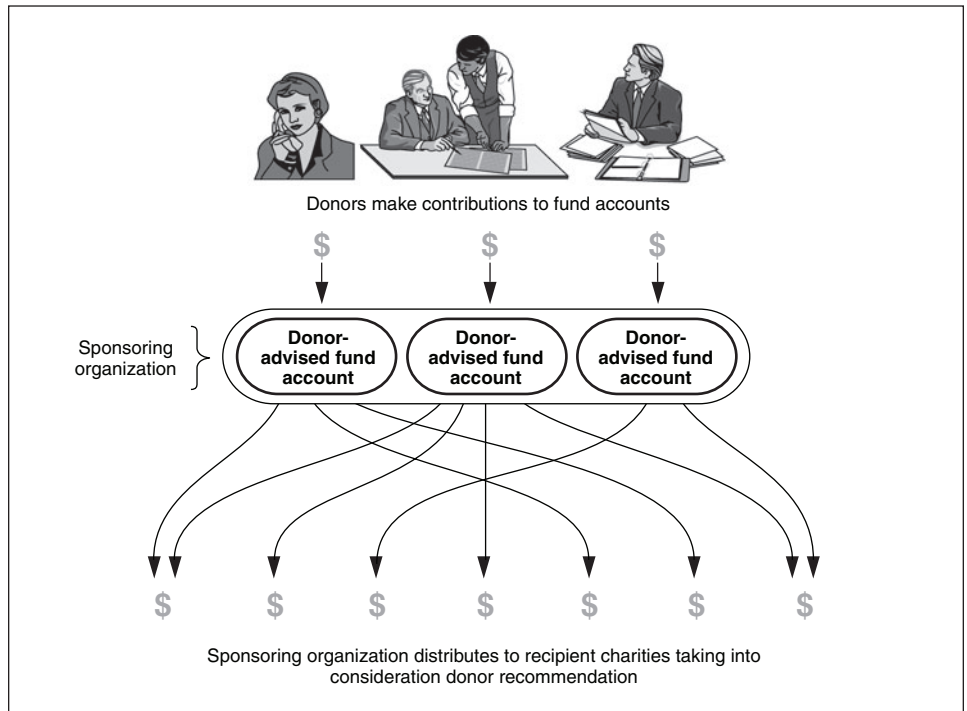
Table 1: Simplified Comparison of Differences and Similarities in Federal Tax Laws for Donor-Advised Funds, Supporting Organizations, and Private Foundations

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

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

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

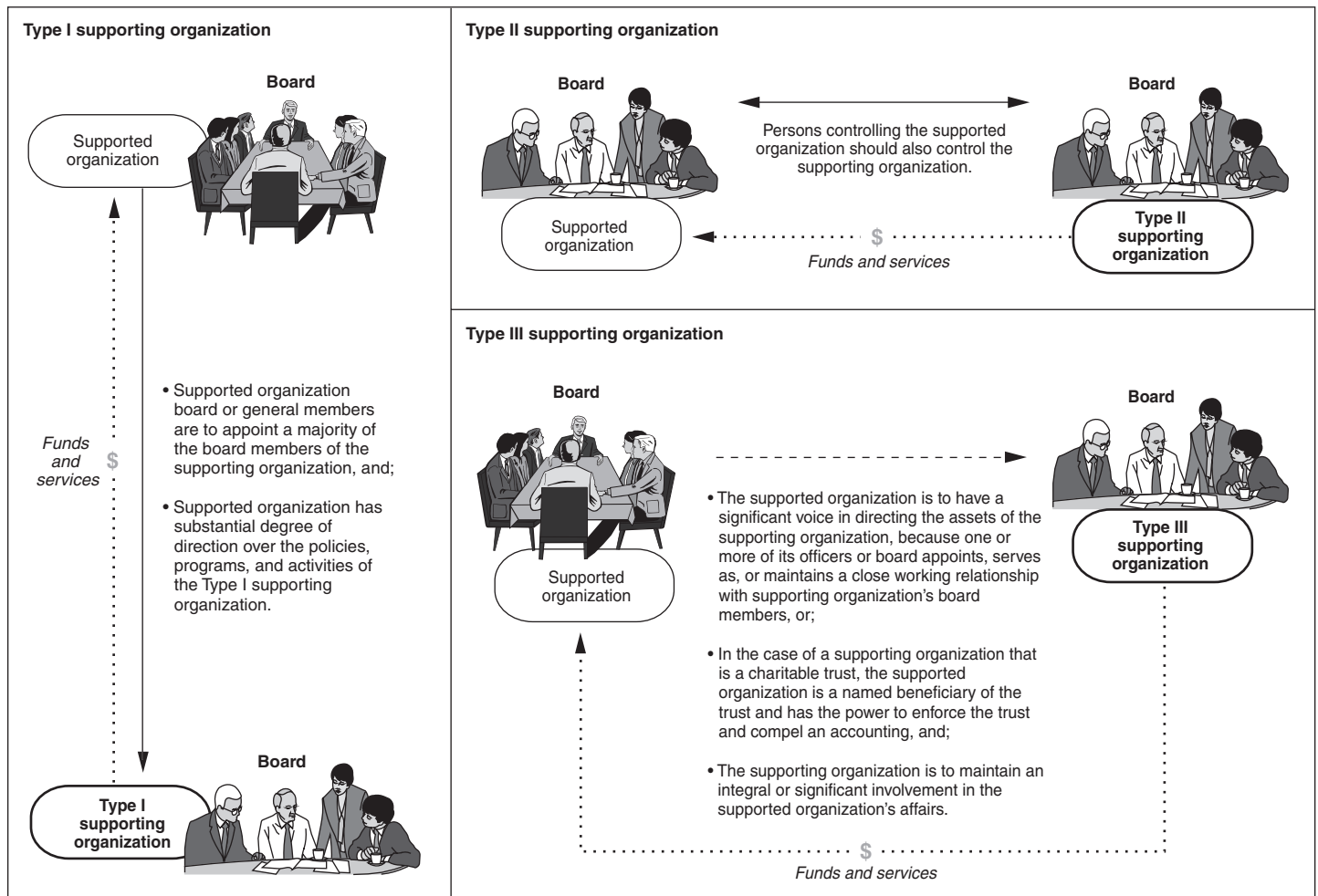
Figure 1: Simplified Example of How Donor-Advised Fund Accounts Operate



Source: GAO (analysis); Art Explosion (images).

Supporting organizations are public charities that are to support one or more public charities or certain other tax-exempt organizations. They fall in between a donor-advised fund and a private foundation in terms of restrictions and sanctions versus donor control over the use of the charitable assets. For example, donors who create a supporting organization avoid private foundation excise taxes and other rules and face fewer restrictions on the deductibility of their donations at the expense of having less control compared to donors at a private foundation, such as involvement on the board. The level of control that the supported charity has over the supporting organization varies by the three basic types of supporting organizations. Type I supporting organizations are “operated, supervised, or controlled by” the supported charitable organization. Type II supporting organizations are “supervised or controlled in connection with” the supported organization. In contrast, Type III supporting organizations only are “operated in connection with” the supported organization (see fig. 2).

Figure 2: Simplified Example of Governance and Structure of Type I, II, and III Supporting Organizations



Source: GAO (analysis); Art Explosion (images).

In reforming the rules for charitable organizations in 1969, Congress made changes to restrict and regulate private foundations more than public charities. Private foundations are generally funded and controlled by a single or small number of donors and therefore may be prone to potential

abuses, particularly by disqualified persons.¹⁸ As a result, private foundations are subject to anti-abuse rules and related sanctions that are not applicable to donor-advised funds, supporting organizations, and public charities as a whole. For example, public charities, including donor-advised fund operators and supporting organizations, are subject to restrictions and two related excise taxes for activities involving political expenditures (section 4955) and excess benefit transactions¹⁹ (section 4958). In contrast, private foundations are subject to six excise taxes²⁰ for activities involving

- investment income²¹ (section 4940);
- self-dealing²² (section 4941);
- failure to distribute income (section 4942);
- excess business holdings (section 4943);
- investments that jeopardize the charitable purpose (section 4944); and
- certain “taxable expenditures” (section 4945).

Although public charities, such as donor-advised fund operators and supporting organizations, and private foundations are subject to different restrictions on transactions with disqualified persons, both excess benefit and self-dealing restrictions are intended to prevent inurement or undue private benefit, which are prohibited for all section 501(c)3 organizations. Inurement is the transfer or use of the charity’s assets or income to or for the benefit of a charity’s insiders. All transactions that more than

¹⁸A disqualified person is an individual, defined in IRC section 4946, who may have a significant conflict of interest with a charity due to financial, executive, or voting powers, such as those held by donors, officers, or directors. The definition applies to individuals involved with private foundations and supporting organizations, and has limited application to public charities other than supporting organizations. See section 4958.

¹⁹An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of a disqualified person, and the value of the economic benefit provided by the organization exceeds the value of the consideration received by the organization.

²⁰See appendix I for a more detailed description of tax-exempt excise taxes.

²¹This excise tax is not related to any perceived abusive activity.

²²Self-dealing includes the following transactions, whether direct or indirect, between a private foundation and a disqualified person: (1) sale, exchange, or lease of property; (2) lending money or other extensions of credit; (3) providing goods, services, or facilities; (4) paying compensation or reimbursing expenses to a disqualified person; (5) transferring foundation income or assets to, or for the use or benefit of, a disqualified person; and (6) certain agreements to make payments of money or property to government officials.

incidentally benefit insiders, other than reasonable compensation and arm's length transactions, are prohibited inurement transactions. Private benefit is a broader concept, and may involve a transfer or use of a charity's assets or income by private persons who are not necessarily insiders. Some private benefit may be allowed, but if present, must be no more than incidental to the exempt purpose being served.

Unlike with donor-advised funds and supporting organizations, a private foundation is required under section 4942 to distribute annually a minimum amount of its funds, equal to approximately 5 percent of the fair market value of the foundation's noncharitable use of assets (generally, stocks and other investments that compose the foundation's endowment). In 1984, Congress passed legislation that clarified what expenses can be included towards meeting this minimum "payout" requirement.²³ If this "payout" rate is unmet, the foundation is subject to paying taxes on the undistributed amount.

**Donor-Advised Funds,
Supporting
Organizations, and
Private Foundations
Hold Billions of
Dollars in Assets, but
Some Organizational
Characteristics
Cannot Be Reliably
Determined from
Form 990 Data**

Donor-advised funds hold billions of dollars in assets, and supporting organizations and private foundations hold hundreds of billions of dollars in assets. Financial data on donor-advised funds are not separately identified and reported on the Form 990. Although some data on donor-advised funds have been collected through an annual survey, these data are incomplete and not statistically representative of the fund population. Using 2003 data from Forms 990 and 990-PF, we found differences between supporting organizations and private foundations. For instance, in 2003, private foundations tended to report more total assets and contributions received but fewer revenues and expenses compared to supporting organizations. However, certain other characteristics of supporting organizations cannot be reliably determined from the Form 990 because this information is either not required to be reported or may be misreported for various reasons, according to IRS. Specifically, supporting organizations are not required to report a payout rate or to pay out a minimum amount of funds to charities, as private foundations must do. IRS has recently revised the Form 990 to better identify supporting organizations and donor-advised funds and is considering additional revisions, but plans to further revise the Form 990 are still preliminary.

²³Pub. L. No. 98-369 (1984).

Limited Data Are Available for Donor-Advised Funds

Data on donor-advised funds are limited because, unlike supporting organizations and private foundations, the funds usually are not entities that file a Form 990 to report their activities. Organizations that maintain donor-advised funds are to file a Form 990 that includes the assets and other aggregate information for all activities, including for donor-advised funds, but data on these funds are not readily identified from the form because these data are not separately reported.

To provide more information about donor-advised funds, *The Chronicle of Philanthropy* has been conducting an annual survey of organizations that maintain donor-advised funds. Started in 2000, the survey focuses on the largest donor-advised funds and collects data such as the total assets held and the amount of grants awarded. For 2003, *The Chronicle of Philanthropy* reported that the 90 organizations participating in its survey held over \$11.9 billion in assets and distributed over \$2.2 billion to charities from their donor-advised fund accounts.²⁴

However, these survey results, which are one of the few data sources available for donor-advised funds, do not represent the entire population of donor-advised funds and also have other data limitations.²⁵ The survey does not try to capture information for all donor-advised funds, as the population of donor-advised funds to be surveyed is unknown, and focuses on the largest funds, such as the 50 largest community foundations, by amount of money raised. Also, while some efforts are made to generate a high response rate and to check unusual responses, the survey response rate has ranged between 53 percent to 57 percent. Further, survey respondents vary from year to year, and the data are self-reported and

²⁴*The Chronicle of Philanthropy's* most recent survey on donor-advised funds was published in May 2006 and collected 2005 data. It reported that 88 organizations participating in the survey held \$15.5 billion in assets and distributed \$3.3 billion to charities. We report 2003 survey data that we adjusted to 2005 constant dollars to be comparable to our other data.

²⁵We did not assess the reliability of the survey results from this and other studies on donor-advised funds. In addition to this survey, in 2001, the Council on Foundations collaborated with the Columbus Foundation to survey donor-advised funds offered by community foundations. The Council on Foundations provides legal and other services to its members and the general public. The Columbus Foundation is a community foundation serving central Ohio. In 2003, the Council on Foundations also collaborated on a study on donor-advised funds focusing on donor preferences. Both of these studies can be found at www.cof.org/files/Documents/Community_Foundations/CF_Columbus_DAF.pdf and www.cof.org/files/Documents/Community_Foundations/External_Reports/FSG2_Oct2003.pdf.

cannot be checked for accuracy. Finally, the survey does not collect data for individual donor-advised fund accounts.

Data on Supporting Organizations Highlight Differences from Private Foundations

From our analysis of Forms 990 and 990-PF, we found that supporting organizations filed nearly 21,400 Forms 990, and private foundations filed over 80,300 Forms 990-PF for tax year 2003.²⁶ Table 2 summarizes differences in the amounts of assets, revenues, expenses, and contributions received when comparing 1999 and 2003. Appendix II provides additional related data, including data for the years 1999 through 2003.

²⁶Data for tax year 2003 were the most recent complete IRS and GuideStar data available at the time of our analysis. In our past work ([GAO-02-526](#)), we have reported that caution in interpreting the data is warranted. No measures are available on the accuracy of the expense data and substantial discretion in allocating the expenses makes use of the data problematic in comparing charities.

Table 2: Selected Financial Characteristics Reported by Supporting Organizations and Private Foundations in 2005 Constant Dollars, Tax Years 1999 and 2003

(Dollars in billions)

	Tax year	Supporting organizations		Private foundations	
		Total	Percentage change	Total	Percentage change
Number of returns filed	1999	20,217	N/A	69,812	N/A
	2003	21,372	6%	80,365	15%
Total assets ^a	1999	\$211.1	N/A	\$428.4	N/A
	2003	239.4	13%	449.5	5%
Total revenue ^b	1999	63.0	N/A	84.6	N/A
	2003	65.0	3%	53.6	-37%
Total expenses ^c	1999	50.0	N/A	40.6	N/A
	2003	55.6	11%	41.1	1%
Total grants paid	1999	8.5	N/A	32.4	N/A
	2003	10.7	27%	31.0	-4%
Total contributions received ^d	1999	14.2	N/A	31.3	N/A
	2003	\$15.5	9%	\$27.7	-12%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System and from GuideStar, 1999 and 2003.

^aTotal assets include cash and investments in securities, land, buildings, and equipment.

^bTotal revenue includes contributions received and dividends and interest earned from the investment of securities.

^cTotal expenses include grants paid, executive compensation, salaries and wages, and other administrative expenses, which can be both program-related and nonprogram-related.

^dTotal contributions received include direct contributions from individuals, indirect contributions through federated fundraising campaigns or affiliate organizations, and government grants.

Table 2 shows that in 2003, the number of private foundations outnumbered the number of supporting organizations by more than a factor of 3, reported over \$200 billion more in assets, and reported more contributions received. However, supporting organizations reported more revenue but also more expenses by 2003 compared to private foundations. Furthermore, comparing 1999 to 2003, supporting organizations tended to report growth in all of these areas while private foundations reported declines in revenue and contributions received. We were unable to determine the reasons for these changes, but the year-to-year variations during 2000, 2001, and 2002, in part due to a significant stock market decline during this time, provided some insights (see app. II for summary tables with annual data). Median values for the dollar amounts reported are shown in table 3.

Table 3: Medians and Related Data for Selected Financial Characteristics Reported by Supporting Organizations and Private Foundations in 2005 Constant Dollars, Tax Years 1999 and 2003

	Tax year	Supporting organizations			Private foundations		
		Median ^a	Percentage change	Percentage returns reporting zero ^b	Median ^a	Percentage change	Percentage returns reporting zero ^b
Total assets	1999	\$1,249,657	N/A	20%	\$392,542	N/A	5%
	2003	1,221,457	-2%	18%	377,827	-4%	6%
Total revenue	1999	286,340	N/A	19%	66,180	N/A	5%
	2003	196,376	-31%	17%	27,632	-58%	6%
Total expenses	1999	164,172	N/A	21%	45,346	N/A	7%
	2003	159,935	-3%	18%	41,019	-10%	6%
Total grants paid	1999	66,001	N/A	49%	41,538	N/A	19%
	2003	73,578	11%	46%	37,079	-11%	18%
Total contributions received	1999	141,474	N/A	55%	57,294	N/A	54%
	2003	\$133,474	-6%	53%	\$41,938	-27%	58%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System and from GuideStar, 1999 and 2003.

^aMedians were calculated using returns reporting a nonzero value for the characteristic being analyzed. A median is the number above and below which 50 percent of organizations fall for the characteristic measured. We present the median because it better represents the typical organization than would the average, which could be affected by extreme dollar values for each measure.

^bAlthough medians were calculated using returns reporting a nonzero value, we included, for context, returns that reported a zero value for these characteristics.

For the four financial characteristics listed in table 3, median values for supporting organizations were much higher compared to private foundations in both 1999 and 2003, in contrast to the higher total values for private foundations listed in table 2. Also, the declines in supporting organization median values between 1999 and 2003 were much less compared to private foundations. We excluded zero values from our median analyses. IRS officials said that organizations might be reporting zero values if filing a final return or for other reasons. However, we were unable to conduct additional analysis on these zero values, particularly for total contributions received in which over 50 percent of the values reported by supporting organizations and private foundations were zero.

Some Financial and Organizational Characteristics of Supporting Organizations Cannot Be Reliably Determined from 990 Data

Some financial characteristics of supporting organizations cannot be reliably determined because they are not required to be reported on the Form 990 or may be misreported. As a result, directly comparing supporting organizations and private foundations or other tax-exempt charitable organizations can pose challenges. Being able to make these comparisons is important in order to address concerns, such as how much and how often supporting organizations pay out to charities, since, like private foundations, supporting organizations can be used to accumulate contributions prior to distributing the money to charity, but, unlike private foundations, they do not have a minimum payout requirement to support charities that must be annually reported.²⁷

Because supporting organizations do not have this payout requirement, they do not explicitly report a payout rate, as is required for private foundations. Certain lines on the Form 990-PF allow IRS, and the public, to determine whether private foundations have met their required payout rate. For supporting organizations, factors that are included in the payout calculation for private foundations might not be readily determined from the Form 990.²⁸ Absent being able to identify these additional data and clarifying how they are to be accounted for in a supporting organization payout rate, consistently comparing supporting organizations' and private foundations' payout rates cannot be done. Similarly, for donor-advised funds, payout rate has not been statutorily required or defined and consequently is also not required to be reported on the Form 990, and available data do not allow a payout rate to be determined.

Despite these difficulties, researchers have studied different ways to compute a payout rate for supporting organizations. A 2005 Urban Institute study found that supporting organization payout rates could vary due to factors such as the purpose of the organization and which lines on the Form 990 were included in determining how much support was

²⁷Type III supporting organizations can demonstrate that they are an integral part of their supported organizations by paying substantially all—85 percent or more—of their income to, or for the use of, one or more of their supported organizations. The amount of support provided must also be enough to ensure the attentiveness of these supported organizations.

²⁸Factors include administrative expenses, program-related investments, trustee fees, amounts set aside for future charitable projects, and monthly average of fair market value of noncharitable use securities.

provided.²⁹ The study pointed out that differences in supporting organization payout rates may reflect differences in the purpose and operation of the supporting organizations, rather than the amount of charitable support provided. For example, some supporting organizations provide operational services to their supported charities, rather than provide grants. Supporting organizations can serve to pool or manage investments or endowments for their supported organization, hold real estate, or provide services, such as office or property management. Payout rates for these types of supporting organizations might indeed be low or infrequent, since these organizations do not hold and distribute charitable funds like other supporting organizations or private foundations whose primary purpose is grant-making.

While the Form 990 includes a supporting organization's grants and net assets, using only those lines to determine a payout rate may provide an incomplete picture of the supporting organization's charitable activity. In 2002, supporting organizations reported over \$7 billion in grants as transfers of charitable support. However, in the Urban Institute study, researchers found that transfers of support from a supporting organization to its supported organizations were reported on 1 or more of at least 10 lines on the Form 990.³⁰ While the amounts reported on these lines might include transfers of support, the Form 990 line data alone are generally not enough to determine how much of the amount reported, if any, supports charities. For example, they found that organizations they sampled sometimes reported transfers of support to a supported organization on the line for rental expenses. However, only by examining Form 990-related documentation, which an Urban Institute researcher said required considerable effort, could they determine this result. In 2003, supporting organizations reported over \$431 million on this Form 990 line, but without significant effort, one cannot determine how much, if any, of this amount consisted of transfers of support to supported organizations.

Another challenge in using Form 990 data to determine financial characteristics arises when analyzing compensation paid to executives and

²⁹Thomas H. Pollak and Jonathan D. Durnford, *The Scope and Activities of 501(c)(3) Supporting Organizations* (Washington, D.C.: Urban Institute), June 2005, <http://www.urban.org/url.cfm?ID=411175> (downloaded Aug. 8, 2005).

³⁰As described by the Urban Institute, transfers of support are the flow of funds from the supporting organization to the supported organization, including grants, payments, and loans.

employees of tax-exempt organizations, such as supporting organizations. In 1999 and 2003, supporting organizations reported over \$894 million and over \$1 billion, respectively, in total executive compensation. Private foundations reported almost \$739 million in 1999 and about \$812 million in 2003 in total executive compensation (see app. II for data tables). Organizations are required to report compensation for certain employees on the Form 990 and Schedule A. However, according to IRS managers, misreporting is not uncommon, although some may be unintentional, in such areas as deferred executive compensation, payments made to relatives, and compensation paid from related entities, such as a for-profit subsidiary of a tax-exempt organization paying the salary of an employee or board member of its parent tax-exempt organization. In addition, an IRS researcher had concerns that compensation could be overreported for tax-exempt organizations within a network, such as a health care network of hospitals. In such networks, which commonly include supporting organizations, compensation for board members can be misreported on the Forms 990 when related organizations have common board members.

IRS is currently working on an initiative to identify and stop abuses by public charities and private foundations that pay excessive compensation and benefits to their officers and other insiders. Beginning in late 2004, IRS contacted a broad spectrum of over 1,800 public charities and private foundations seeking information about their compensation practices and procedures. IRS also just started a new phase of the initiative, involving an additional 250 contacts about loans to officers, directors, and key employees. The goals for the initiative are to

- learn how exempt organizations determine and manage compensation;
- gauge the existence and effectiveness of exempt organizations' controls over compensation issues;
- learn how exempt organizations report compensation on Forms 990 and 990-PF;
- address instances of questionable compensation practices, as well as compensation of specific individuals; and
- increase exempt organizations' awareness of compensation-related tax issues.

The initial results of the compensation initiative will be included in a report that is expected to be completed in late August or September 2006. All examinations are expected to be completed by or during 2007.

In addition to financial characteristics such as payout rate and executive compensation, organizational characteristics about supporting

organizations are difficult to determine from the Form 990. For example, Form 990 does not collect the EINs of their supported organizations, which according to IRS officials, would facilitate IRS's ability to track the flow of donations. In addition, an IRS manager said that having supported organizations' EINs would facilitate IRS's ability to track how compensation is treated between supporting organizations and supported organizations. IRS emphasized that any form changes must be balanced against the increased burden on taxpayers of supplying additional information.

Other organizational characteristics for which IRS collects limited data on Form 990 include relationships with foreign entities, noncash contributions, loan recipients, and donor information. We were unable to closely evaluate these characteristics because IRS had limited data and information to provide and because of time constraints. Although the costs and burdens of collecting additional data to determine these organizational characteristics and protecting taxpayer privacy are legitimate concerns, IRS has acknowledged the need for greater transparency and better data to track the flow of funds between donors and charities. For example, IRS does not have TINs of loan recipients to track the flow of funds.

IRS Has Made and Is Considering Changes to the Form 990 Regarding Donor-Advised Funds and Supporting Organizations

IRS has begun to take steps to help address the lack of information reported on donor-advised funds and supporting organizations. For example, IRS has revised the 2005 Form 990 Schedule A to include a check box to indicate whether a supporting organization is Type I, II, or III.³¹ This information will be transcribed into IRS's electronic databases beginning in 2007, which, according to IRS, would allow it to better focus its examination and educational resources on compliance issues particular to each type. Also, starting with the 2003 Form 990 Schedule A, organizations must indicate whether they maintain separate accounts for donors, such as donor-advised funds. In January 2006, IRS began transcribing this information, which is a first step towards identifying how many and which charities have donor-advised funds. However, these organizations are not required to separately report data on the donor-advised funds from the other activity reported on the Form 990, meaning that data on the funds are not easily identified. While IRS is considering revising the Form 990 to include more information about donor-advised funds, it does not have

³¹Supporting organization type is now also being indicated on IRS's determination letters.

details on what data they might collect or how or when they would revise the form.

IRS is considering additional changes to the Form 990 that, pending management approval, would include reorganizing the form in stages. A pending proposal includes recommendations to create new sections or schedules on the Form 990 with questions on donor-advised funds and supporting organizations. Because the Form 1023 asks questions regarding donor-advised funds and supporting organizations, the proposal recommends aligning the Form 990 with Form 1023 so that IRS can track a charity from its formation. If the recommendation is approved, IRS's Form 990 Redesign Team plans to rewrite the Form 990 instructions and add a glossary consistent with the Form 1023 which, according to IRS, may provide better data.

According to IRS staff and others we interviewed, these form revisions, along with increased use of electronic filing, could improve the quality of data available to IRS to better identify noncompliance through its research and compliance efforts, as well as to the public to improve the effectiveness of tax-exempt charitable organizations.

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

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

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

Private Benefit and Inurement Lead to Personal Gains

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

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

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

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

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

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

Donor Control May Involve Assets or Charity Operations

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

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

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

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

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

Other Types of Noncompliance Exist

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

Matters for Congressional Consideration

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

Recommendations for Executive Action

To better understand the characteristics of donor-advised funds and supporting organizations and to better identify possible noncompliance, the Commissioner of Internal Revenue should, as part of the Form 990 revision process, (1) require more comprehensive reporting of donor-advised fund activity, (2) require supporting organizations to report their supported organizations' EINs, and (3) require that the TINs for recipients of large loans be reported, if IRS is granted authority to protect the TINs from public disclosure.

Agency Comments

The Commissioner of Internal Revenue provided written comments on a draft of this report in a July 19, 2006, letter, which is reprinted in appendix V. IRS said our recommendations would help it deter abuse within tax-exempt and government entities and the misuse of such entities by third parties. IRS agreed with our two recommendations regarding requiring more comprehensive reporting of donor-advised fund activity and requiring supporting organizations to report their supported organizations' EINs on the Form 990. IRS said it will consider these form changes as part of the Form 990 revision process, but the timing of these revisions will depend on available resources. IRS also said that reporting supported organizations' EINs would potentially help with early identification of abuses involving promoters and donors getting back their donations in the form of a purported loan that may never be repaid. Regarding our third recommendation, which had been to require that the TINs for large-loan recipients be reported on the Form 990, IRS agreed that greater transparency and better tracking of loans are needed. However, IRS did not believe that it had the authority under current law to protect the TINs of loan recipients from public disclosure if the TINs were reported on the Form 990. As a result, we have added a matter for congressional consideration to provide IRS the authority to protect loan recipient TINs on the Form 990 from public disclosure and revised the recommendation so that if provided the authority to protect the information from public disclosure, IRS should revise the Form 990 to collect loan recipient TINs.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Ranking Minority Member, the Senate Committee on Finance; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties. We will make copies available to others on request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staff have any questions about this report, please contact me at (202) 512-9110 or brostekm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix VI.

Sincerely yours,

A handwritten signature in black ink that reads "Michael Brostek". The signature is written in a cursive, flowing style.

Michael Brostek
Director, Tax Issues
Strategic Issues

Appendix I: Tax-Exempt Excise Taxes

Over the years, Congress has imposed various excise taxes that affect tax-exempt entities, particularly private foundations under section 501(c)(3). Public charities differ in several ways from private foundations. Public charities have broad public support and tend to provide charitable services directly to beneficiaries. Private foundations are often tightly controlled and receive a significant portion of their funds from a small number of donors, and tend to make grants directly to other organizations rather than directly provide charitable services. Since these differences create the potential for self-dealing or abuse by a small group, private foundations are subject to anti-abuse rules not applicable to public charities. In addition, both public charities and private foundations are generally prohibited from engaging in certain types of transactions. Excise taxes are to be levied on public charities and private foundations, as well as a few other types of tax-exempt entities, that violate the rules. Details on these rules and excise taxes follow.

Excise Tax on Section 501(c)(3) Political Expenditures (Section 4955)

Section 4955 was added by the Revenue Act of 1987, P.L. 100-203. According to the House Report¹ for the Act, the committee believed that the excise tax applicable to private foundations for making prohibited political expenditures (section 4945) should also apply to public charities. Section 4955 imposes an initial 10 percent excise tax on each political expenditure of a section 501(c)(3) organization. An additional 2-½ percent excise tax is imposed on the organization's manager if the manager knew that it was a political expenditure. Political expenditures include any amounts paid or incurred by the organization in any participation or intervention in any political campaign on behalf of any candidate for public office. If an initial tax has been imposed regarding a political expenditure and that expenditure is not corrected, an additional tax equal to 100 percent of the amount is to be imposed on the organization. An additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the organization's manager if that manager refuses to agree to part or all of the correction.

Excise Tax on Section 501(c)(3) and (4) Excess Benefit Transactions (Section 4958)

Section 4958 was added in 1996 by the Taxpayer Bill of Rights 2, P.L. 104-168. According to the related House Report² this excise tax was added to ensure that the advantages of tax-exempt status benefit the community and not private individuals. The act provided for this intermediate sanction (i.e., something short of a loss of tax-exemption) to be imposed when

¹H. Rep. No. 100-391 (1987).

²H. Rep. No. 104-506 (1996).

nonprofit organizations engage in transactions with certain insiders that result in private inurement. Section 4958 imposes an initial tax of 25 percent on each excess benefit transaction entered into between a disqualified person and tax-exempt organizations under sections 501(c)(3) and (4). The initial tax is to be paid by this disqualified person, including any person who at any time during the 5-year period ending on the date of the transaction was in a position to exercise substantial influence over the organization, a member of this person's family, and a 35 percent controlled entity. Such an entity exists when a disqualified person owns more than 35 percent of the voting power of a corporation, more than 35 percent of the profit interest of a partnership, or more than 35 percent of the beneficial interest of a trust or estate. If an initial tax is imposed on the disqualified persons, an additional tax of 10 percent is to be imposed on the organization's manager if that manager participated knowing that it was an excess benefit transaction. If the excess benefit transaction is not corrected within the taxable period, a tax equal to 200 percent of the excess benefit transaction will be imposed on the disqualified person. Private foundations are not subject to this excise tax.

Excise Tax on Private Foundation Investment Income (Section 4940)

Section 4940 was added by the Tax Reform Act of 1969, P.L. 91-172. The related Senate Report³ described the excise tax as an "audit fee tax" that was believed to be necessary to cover IRS's costs for increased supervision over private foundations under the act. Section 4940 imposes a 2 percent excise tax on the net investment income of tax-exempt private foundations. Net investment income includes income from interest, dividends, and net capital gains that is reduced by the expenses incurred to earn it. This tax is 1 percent if a private foundation meets certain distribution requirements. Private foundations that meet the requirements to be an "exempt operating foundation" are not subject to this excise tax. Among these requirements are stipulations that the foundation be publicly supported for at least 10 years and that it have a governing body that is broadly representative of the general public. Private foundations that are not exempt from taxation are subject to this excise tax and unrelated business income tax.

Excise Tax on Private Foundation Acts of Self-Dealing (Section 4941)

Because a tax-exempt entity cannot operate to confer a benefit on private parties, Section 4941 was enacted by the Tax Reform Act of 1969. According to the Senate Report, generally prohibiting self-dealing transactions would minimize the need to apply the subjective arm's-length

³S. Rep. No. 91-552 (1969).

standard that was used for loans, payments of compensation, and preferential availability of services under the 1950 amendments. Section 4941 imposes a 5 percent excise tax on acts of self-dealing between a private foundation and disqualified persons. This tax is to be paid by the disqualified person who participated in the self-dealing. An additional tax equal to 200 percent of the amount involved is to be imposed if the self-dealing is not corrected during the taxation period. A separate tax equal to 2-½ percent of the amount involved is to be imposed on the foundation's manager if that manager knowingly participated in the act of self-dealing. If this additional tax has been imposed on the foundation manager and that manager refuses to agree to part or all of the correction, an additional tax equal to 50 percent of the amount is to be imposed. Acts of self-dealing include sales, exchanges, or leases of property; lending of money or other extensions of credit; and payment of compensation. Disqualified persons include substantial contributors to the foundation, foundation managers, an owner of more than 20 percent of a business enterprise that is a substantial contributor, and certain government officials.

Excise Tax on Private Foundation Failure to Distribute Income (Section 4942)

Section 4942 was enacted by the Tax Reform Act of 1969. Prior to it, a private foundation could lose its exemption if it failed to make distributions towards its charitable purposes instead of just accumulating income. According to the Senate Report, the committee believed that loss of exempt status as the only sanction was often ineffective or harsh, and that substantial improvement could be achieved by providing a graduation of sanctions if income is not distributed. Section 4942 imposes a 15 percent excise tax on the undistributed income of a private foundation for any taxable year in which the required amount has not been distributed before the first day of the next taxable year. If an initial tax has been imposed under section 4942 and the income remains undistributed at the end of the taxable period, a tax equal to 100 percent of the remaining undistributed amount is to be imposed. This excise tax does not apply to private operating foundations that meet distribution requirements or to the extent that the failure to distribute is due solely to an incorrect valuation of assets as long as other requirements are met.

Excise Tax on Private Foundation Excess Business Holdings (Section 4943)

Section 4943 was enacted by the Tax Reform Act of 1969. According to its Senate Report, the use of foundations to maintain control of a business appeared to be increasing, and some who wished to use a foundation's stock holdings to control a business were relatively unconcerned about producing income for charitable purposes. Where the charitable ownership predominated, the business could unfairly compete with businesses whose owners were required to pay taxes on their business income. The committee concluded that a limit on the extent to which a

private foundation may control a business was needed. Section 4943 imposes a 5 percent excise tax on certain excess business holdings of a private foundation. Permitted holdings generally include up to 20 percent of the voting stock of an incorporated business enterprise (reduced by the percentage of the voting stock owned by all disqualified persons) and similar holdings in partnerships and other unincorporated enterprises (except sole proprietorships). If the excise tax has been imposed, foundations that fail to make the required divestiture of excess holdings above the permitted amounts are subject to an additional tax equal to 200 percent of the excess holdings. In certain cases, foundations are allowed a 5-year period to dispose of the excess holdings and may receive an additional 5-year extension.

Excise Tax on Private Foundation Investments Which Jeopardize Charitable Purpose (Section 4944)

Section 4944 was enacted by the Tax Reform Act of 1969. Under prior law, a private foundation could lose its exemption if it invested in a manner that jeopardized its exempt purpose. In the Senate Report, the committee concluded that limited sanctions were preferable to the loss of exemption. Section 4944 imposes an initial 5 percent excise tax on the amount involved if a private foundation invests in a manner that jeopardizes its exempt purpose (e.g., investing with the purpose of income production or property appreciation). If this tax is imposed on the foundation, a separate 5 percent excise tax is to be imposed on the foundation manager if that manager knew that making the investment would jeopardize the foundation's exempt purpose. If an initial tax is imposed, an additional tax equal to 25 percent of the amount of the investment is to be imposed on the foundation if the investment is not withdrawn within the taxable period. An additional tax equal to 5 percent of the amount of the investment is to be imposed on the foundation manager if the investment is not withdrawn.

Excise Tax on Private Foundation Taxable Expenditures (Section 4945)

Section 4945 was enacted by the Tax Reform Act of 1969. Under prior law, the only sanction against prohibited political activity by a foundation was loss of exemption. The Senate Committee Report noted that the standards for determining the permissible level of political activity were so vague as to encourage subjective application of the sanction. As a result, section 4945 was added to clarify the types of impermissible activities and provide more limited sanctions. Section 4945 imposes an initial 10 percent excise tax on each taxable expenditure made by the foundation. An additional 2-½ percent excise tax is to be imposed on the foundation manager if that manager knowingly participated in the taxable expenditure. Taxable expenditures include amounts paid to carry on propaganda or otherwise influence legislation or the outcome of a public election, or to directly or indirectly carry on a voter registration drive. If the expenditure is not

corrected within the taxable period, an additional tax equal to 100 percent of the amount of the expenditure is to be imposed on the foundation and an additional tax equal to 50 percent of the amount of the expenditure is to be imposed on the foundation manager.

Appendix II: Summary Data Tables for Section 501(c)(3) Tax-Exempt Charities in 2005 Constant Dollars, Tax Years 1999-2003

The following tables summarize data reported on the annual Forms 990 and 990-PF filed by tax-exempt charitable entities under section 501(c)(3) of the Internal Revenue Code. The tables cover number of returns filed and the reported totals for the following characteristics: assets, revenues, expenses, contributions received, noncash contributions received, grants paid, and executive compensation. The data are categorized by supporting organizations, private foundations, and all other 501(c)(3) charities.

Table 4: Number of Returns Filed, Tax Years 1999 through 2003

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	20,217	N/A	69,812	N/A	280,033	N/A
2000	20,817	3%	74,056	6%	283,826	1%
2001	21,466	3%	77,229	4%	301,043	6%
2002	21,057	-2%	80,631	4%	289,381	-4%
2003	21,372	1%	80,365	0%	298,897	3%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

Table 5: Total Assets Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$211.1	N/A	\$428.4	N/A	\$1,514.1	N/A
2000	213.5	1%	470.5	10%	1,544.1	2%
2001	214.6	1%	451.9	-4%	1,583.1	3%
2002	215.8	1%	447.8	-1%	1,546.7	-2%
2003	\$239.4	11%	\$449.5	0%	\$1,646.3	6%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

**Appendix II: Summary Data Tables for
Section 501(c)(3) Tax-Exempt Charities in
2005 Constant Dollars, Tax Years 1999-2003**

Table 6: Total Revenue Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$63.0	N/A	\$84.6	N/A	\$896.4	N/A
2000	62.5	-1%	84.4	0%	915.8	2%
2001	55.2	-12%	50.0	-41%	934.0	2%
2002	55.4	0%	35.6	-29%	925.6	-1%
2003	\$65.0	17%	\$53.6	51%	\$987.4	7%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

Table 7: Total Expenses Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$50.0	N/A	\$40.6	N/A	\$806.5	N/A
2000	53.3	6%	44.0	8%	845.2	5%
2001	51.3	-4%	43.5	-1%	894.6	6%
2002	52.9	3%	41.6	-4%	903.3	1%
2003	\$55.6	5%	\$41.1	-1%	\$927.5	3%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

**Appendix II: Summary Data Tables for
Section 501(c)(3) Tax-Exempt Charities in
2005 Constant Dollars, Tax Years 1999-2003**

Table 8: Total Contributions Received Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$14.2	N/A	\$31.3	N/A	\$195.9	N/A
2000	16.3	14%	36.0	15%	211.8	8%
2001	14.7	-10%	31.3	-13%	225.0	6%
2002	13.3	-9%	25.2	-19%	211.9	-6%
2003	\$15.5	17%	\$27.7	10%	\$219.4	4%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

Table 9: Total Noncash Contributions Received Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations ^a	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$2.7	N/A	N/A	N/A	\$16.7	N/A
2000	2.6	-1%	N/A	N/A	20.3	22%
2001	2.6	-2%	N/A	N/A	21.0	3%
2002	1.8	-30%	N/A	N/A	18.0	-14%
2003	\$2.4	33%	N/A	N/A	\$25.8	43%

Source: GAO analysis of data from GuideStar, 1999 through 2003.

^aUnlike organizations that file a Form 990, private foundations do not report the amount of noncash contributions received on the Form 990-PF.

**Appendix II: Summary Data Tables for
Section 501(c)(3) Tax-Exempt Charities in
2005 Constant Dollars, Tax Years 1999-2003**

Table 10: Total Grants Paid Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$ 8.5	N/A	\$32.4	N/A	\$42.6	N/A
2000	11.3	33%	34.9	8%	45.5	7%
2001	8.0	-29%	35.9	3%	48.2	6%
2002	7.9	-2%	33.9	-6%	47.4	-2%
2003	\$10.7	37%	\$31.0	-9%	\$58.2	23%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System for private foundations, and from GuideStar for supporting organizations and all other 501(c)(3) tax-exempt charities, 1999 through 2003.

Table 11: Total Executive Compensation Reported by Section 501(c)(3) Organizations in Constant 2005 Dollars, Tax Years 1999 through 2003

(Dollars in billions)

Tax year	Supporting organizations	Percentage change	Private foundations	Percentage change	All other 501(c)(3) tax-exempt charities	Percentage change
1999	\$0.9	N/A	\$0.7	N/A	\$11.1	N/A
2000	1.0	6%	0.8	8%	11.5	3%
2001	1.0	4%	0.9	9%	12.9	12%
2002	1.0	2%	0.8	-3%	12.8	-1%
2003	\$1.1	7%	\$0.8	-4%	\$13.0	2%

Source: GAO analysis of data from IRS's Returns Inventory and Classification System, 1999 through 2003.

Appendix III: Noncash Contribution Valuation Methods

IRS's Publication 561 provides guidance to taxpayers on determining the value of property donated to qualified organizations. It defines "fair market value" (FMV) as the price a willing, knowledgeable buyer would pay a willing, knowledgeable seller when neither has to buy or sell. Future events that may affect the property cannot be included in FMV unless they are known at the time of the donation. In addition, past events, such as rapid growth of value over the short term, may have to be balanced out over a longer time frame for a realistic projection of value. While there is no single method to determine FMV, factors to consider include the cost or selling price, sales of comparable properties, replacement costs, and opinions of experts.

Although there are many categories of noncash contributions including vehicles, used clothing, and works of art that charities may receive, donor-advised funds and supporting organizations typically receive larger noncash gifts, according to IRS.

For stocks and bonds, the fair market value is the average price between the highest and lowest trading price on the date of donation. This method is only to be used for items for which an active market exists. If the item is traded on multiple exchanges, then the principle exchange must be used. In addition, large blocks of stock may require an expert to assist in the appraisal.

For closely-held securities, determining FMV would include considering the company's net worth, prospective earning power, dividend-paying capacity, and other factors such as the economic outlook in the particular industry and the company's relative position within it, and the value of securities of companies engaged in the same or similar business.

For real estate, a detailed appraisal by a qualified appraiser is required. Certain items must be included such as complete description, legal description, lot and block number, physical features, condition, dimension, zoning, and potential uses. Three valuation methods may be used—comparable sales, capitalization of income, and replacement cost new or reproduction cost minus observed depreciation (this method used alone does not determine FMV but rather tends to set the upper limit of value).

IRC section 170, particularly Sec 170(f)(8), provides the basis for reporting noncash charitable contributions, such as using a qualified appraiser. The

American Jobs Creation Act of 2004¹ also contains provisions regarding noncash contributions, including requiring the donor to attach a qualified appraisal to the tax return if the contribution is over \$500,000.

Taxpayers are required to file IRS Form 8283 (Noncash Charitable Contributions) if the charitable tax deduction claimed is greater than \$500. Form 8283 should be filed for the tax year that the deduction is claimed. Different sections of the form are to be completed based on type of property donated and whether the amount claimed is less than or greater than \$5,000. Generally appraisals are required by a qualified appraiser for donations of more than \$5,000. Charitable organizations receiving donated property must file Form 8282 to report information to IRS about disposition of certain charitable deduction property made within 2 years after the donor contributed the property.

According to an IRS manager, closely-held stock is a growing concern and challenge to IRS, since it can involve a broad base of taxpayers. He added that artwork, while well-publicized in terms of valuation issues, is less of a concern since the dollar amounts involved are small compared to other types of noncash contributions. In addition, the IRS manager identified the following challenges to addressing noncompliance, gathered from about 100 examination cases:

- donors are sometimes vague when describing the contribution on Form 8283, impeding IRS's understanding and ability to address any problems;
- donors can submit Form 8283 upon examination, creating problems with detecting problems early;
- corporate donors of patents can structure the contribution (e.g., pay maintenance fees on the patent) so that the donee is not required to file a Form 8282 upon disposition of the contribution;
- no requirement exists that noncash contribution amounts reported on a donor's tax return and a charity's Form 990 must match;
- donors take improper deductions without adverse impact to the charity; and
- multiple appraisals of contribution value are not helpful because appraisals are very subjective.

¹ Pub. L. No. 108-357 (2004).

To address some of these concerns, IRS has several initiatives looking at specific types of noncash contributions, such as vehicle donations and art valuations. Additionally, IRS has a program that compares valuations of noncash contributions claimed by taxpayers (on Form 8283) with the price obtained by recipient charities when they resell the property. IRS has used data from this program to complete a study of large noncash contributions.

Appendix IV: Methods and Materials Used to Market Donor-Advised Funds and Supporting Organizations to Potential Donors

Earlier in this report, we discussed some of the methods and materials used to publicize donor-advised funds and supporting organizations that may lead to noncompliance with tax laws. The following is a discussion of donor motivations and materials and methods that are not intended to lead to abusive schemes. To obtain this information, we spoke with 11 community foundation managers, 6 financial professionals, and 18 managers at IRS. The examples we discuss come from materials that we were referred to or located online based on our interviews, and do not necessarily represent all materials and methods used to market donor-advised funds and supporting organizations.

Because donor-advised funds and supporting organizations are just two among many charitable giving options, potential donors must select an option that best suits their goals and donation plan. Factors that may influence a donor's decision include: types of causes they wish to support, the size and type of donation they wish to give, and their desired involvement level in directing the use of their donation. For example, some donors, who desire to donate to a specific community or to have in-depth information on charities receiving their funds, might find that a donor-advised fund administered by a community foundation is an appealing option. Community foundations, which typically have a local focus, may do particularly well at performing due diligence on charities receiving their funds, according to one estate planner. Due diligence may include identifying organizations listed in IRS Publication 78,¹ or interacting with exempt organizations that are potential recipients of funds, according to community foundation managers.

To evaluate giving options in relation to their goals, donors may seek information from accountants, financial planners, lawyers, community foundations, the Internet, and tax-exempt organizations, among others. Some exempt organizations' efforts to market donation options tend to be limited, according to a study by a nonprofit philanthropic research and development organization. This makes personal and business relationships important ways for donors to learn about donor-advised funds and supporting organizations, according to community foundation managers. Because many donor-advised funds are administered by community foundations or are housed in charities affiliated with commercial

¹IRS's Publication 78, the *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, contains a list of all organizations eligible to accept tax-deductible donations.

investment firms, such as Vanguard and Fidelity, these relationships may be particularly important sources for introducing donors to donor-advised funds, according to a community foundation manager interviewed by *The Chronicle of Philanthropy*. According to several community foundation managers, many donors to community foundation donor advised funds are referred from professional advisers. Recognizing the importance of these relationships, some community foundations have launched specific outreach efforts aimed at financial advisers and other professionals who could refer donor-advised fund clients.

In addition to discussions with professionals, donors may encounter or be presented with a variety of material explaining charitable giving options. Material may contain details of giving options in relation to both tax incentives to the donor and charitable benefits for the exempt organization. Some firms advertise services for clients in magazines or national publications, according to IRS managers and an estate lawyer, while others depend on the Internet. Descriptions of professional services can include outlines of charitable giving options, some of which attempt to explain giving options based on the legal, practical, and charitable characteristics of each option. For example, some community foundations, philanthropy organizations, and investment firms provide tables or descriptions comparing various combinations of donor-advised funds, supporting organizations, private foundations, and other donation options. These tables describe and compare levels of donor involvement, tax status, deductions by asset type, start-up costs, and administrative requirements. Other material outlines the steps and requirements necessary to establish a donor-advised fund or supporting organization.

Appendix V: Comments from the Internal Revenue Service



COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

July 19, 2006

Mr. Michael Brostek
Director, Tax Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Brostek:

I am pleased to respond to your draft report concerning donor-advised funds and supporting organizations and ways in which collecting more data on these entities could enhance compliance (GAO-06-799).

I welcome your study. One of the IRS's strategic objectives is to deter abuse within tax-exempt and government entities and the misuse of such entities by third parties for tax avoidance and other unintended purposes. Your report makes several recommendations that can help us meet that objective.

The recommendations address aspects of a project we currently have underway to redesign the Form 990, the annual information report filed by many public charities. Our goal, an aggressive one which is still subject to available funding, approval of major design considerations, and final approval of schedule, is to complete this project in stages for the 2009 filing season. As part of the first stage, we plan to release a draft revised Form 990 for public comment no later than May 2007. The draft will present information about public charities in a more coherent fashion, contain new and clearer instructions, and include a glossary of terms. We plan to take comments we receive from the public into account in a subsequent revision, and add questions related to organizational governance, compensation, and related-party transactions.

In the next stage, we plan to revise the revenue and expense statements and the balance sheet. We also plan to create new sections for areas of special concern, including donor-advised funds, supporting organizations, and health care/hospitals. At that point, the Form 990 will be a superior information return that increases the transparency of the operations of tax-exempt organizations and improves the usefulness of the Form 990 as a compliance tool.

In the final stage, we plan to harmonize the Form 990 with the Form 1023, and will consider the creation of new sections for additional areas of special concern, such as credit-counseling, low-income and elderly housing, gaming, and professional fundraising.

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This comprehensive revision of the Form 990 is a matter of interest and concern not only to the IRS, but also to the exempt organizations community generally, to state charity regulators, and to our partners in the software industry who provide Form 990-related software. The 990 project requires close consultation among the affected parties, and the development and introduction of new software. We are looking for ways to accelerate the project as much as possible, but recognize that it will require steady funding and several years to complete.

Our response to the report's three recommendations is enclosed. If you have any questions, please contact Lois G. Lerner, Director of Exempt Organizations, Tax Exempt and Government Entities Division at (202) 283-2300.

Sincerely,



Mark W. Everson

Enclosure

2

Enclosure

Recommendation 1: require more comprehensive reporting of donor-advised fund activity as part of the Form 990 revision process.

The IRS agrees with this recommendation. We are now conducting compliance work on donor-advised funds. One type of fund we are addressing is the large commercial donor-advised fund, often associated with large investment firms. We also are examining organizations that appear to be abusing the basic concepts underlying donor-advised funds. More comprehensive reporting of donor-advised fund activity on an organization's Form 990 could help expose this sort of abuse and enhance tax compliance. Your staff has been in contact with IRS personnel working on the on-going comprehensive revision of the Form 990, and we will incorporate this recommendation as part of the revision process. We expect this phase of the project to be completed for filings due in 2009, subject to approval of final design and available funding.

Recommendation 2: require supporting organizations to report their supported organization's employer identification number as part of the Form 990 revision process.

The IRS agrees with this recommendation. We have undertaken a compliance project to examine organizations that have been established by promoters, and are finding abuse in this area. An identifying characteristic of these cases is that a donor makes a "charitable" contribution to the supporting organization. The supporting organization then returns the donated amount to the donor, often in the form of a sham loan that may never be repaid. Reporting the supported organization's employer identification number on the Form 990 could aid us in the early identification of this type of abuse. Our current schedule is to include this change in a revision of the Form 990 to be available by December 31, 2007, subject to approval of final design considerations and available funding.

Recommendation 3: require reporting of the taxpayer identification number (TIN) for recipients of large loans, while safeguarding taxpayer privacy, as part of the Form 990 revision process.

The IRS agrees that there is a need for greater transparency within donor-advised funds and for tracking the flow of funds from donors and charities. However, under current law, we do not believe that we can protect the TINs of individual loan recipients from public disclosure if the TINs are entered on a Form 990. Section 6033 of the Internal Revenue Code requires an annual information return to be filed by organizations exempt from taxation under section 501(a), with certain specified exceptions. Section 6104 of the Code requires that information required to be furnished by section 6033 be disclosed and made available for public inspection both by the IRS and by the organization. Sections 6104(b) and 6104(d)(3)(A) provide that the names and addresses of contributors to an organization which is not a private foundation within the

meaning of section 509(a) or a political organization exempt from taxation under section 527 are excepted from disclosure. However, there is no corresponding provision that would protect information concerning loan recipients.

We have considered whether we could redact the TINs of loan recipients before releasing Forms 990 to the public, or in some other manner protect this information from public disclosure, but we have concluded that we cannot do so under the statute. Implementation of this recommendation therefore would require the IRS to disclose individual taxpayer identification numbers to the general public. This is inconsistent with the expectation of taxpayer privacy that individual taxpayers generally have when they provide such sensitive information to the IRS. We therefore cannot agree with this recommendation.

Appendix VI: GAO Contact and Staff Acknowledgments

GAO Contact

Michael Brostek, (202) 512-9110

Acknowledgments

In addition to the contact named above, Tom Short, Assistant Director; Mark Bondo; Marta Chaffee; Elizabeth Fan; Evan Gilman; Nancy Hess; Shirley Jones; Donna Miller; John Mingus; Coltrane Stansbury; Paul Thacker; and Lindsay Welter made key contributions to this report.

Glossary

Charity insider	An individual such as an officer, board member, or other persons able to exercise substantial influence over a tax-exempt organization. Donors to donor-advised funds are rarely considered to be insiders, while donors to supporting organizations can sometimes be insiders if they also serve on the supported organization's board.
Community foundation	An organization, usually a nonoperating charity, providing charitable support through grants to local or regional communities. Typically a community foundation will aggregate contributions from local residents, build endowments, and distribute grants to communities.
Disqualified person	An individual, defined in IRC section 4946, who may have a significant conflict of interest with a charity due to financial, executive, or voting powers, such as those held by donors, officers, or directors. The definition applies to individuals involved with private foundations and supporting organizations, and has a limited application to public charities that are not supporting organizations.
Donor-advised fund	Charitable giving accounts that are held by a public charity. A donor contributes to an individual account within a charity's donor-advised fund, and maintains an advisory role on distribution of the funds. No statutory or regulatory definition currently exists.
Donor control	Authority exerted by a donor that exceeds what is allowable for a donor-advised fund or supporting organization. Donor control includes direct or indirect power over decisions regarding an organization's assets or operations.
Excess benefit	A transaction, directly or indirectly, between a disqualified person and a tax-exempt organization that results in economic benefit to the disqualified person exceeding the value of service to the organization. Subject to excise taxation under IRC section 4958.
Excise tax	A tax imposed on an act, occupation, privilege, manufacture, sale, or consumption and that is usually designed to influence taxpayer behavior.

Expenditure responsibility process A set of procedures used by private foundations to ensure responsible use of grants to charities. The assessment may include:

a pre-grant inquiry on the recipient charity, establishment of commitments for grant recipient, investment requirements, or agreements on actions if agreements are violated.

Intermediate sanctions Excise taxes that provide a corrective remedy for excess benefit transactions. The excise taxes are paid by the disqualified person, as defined in IRC 4958, who receives excess benefit, or by a charity manager who knowingly participates in the transaction.

Inurement The transfer or use of a charity's assets or income for the benefit of a charity's insiders. Inurement is a specific form of private benefit, and is prohibited for all 501(c)(3) organizations.

IRS Form 1023 Application for Recognition of Exemption under IRC Section 501(c)(3) that organizations must file in order to receive tax-exempt status.

IRS Form 990 IRS information return that public charities are required to file annually unless the organization is a church or entity associated with a church, a certain type of governmental unit affiliate, or falls below certain gross receipts thresholds.

IRS Form 990-PF IRS information return that private foundations must file annually.

Noncash contribution An asset other than cash donated to a tax-exempt organization, for example, stocks, bonds, vehicles, artwork, or real estate.

Payout An organization's expenditures to individuals or charities for certain operational or administrative functions. Private foundations must distribute about 5 percent of the average market value of their noncharitable use assets, generally stocks or other investments that compose the foundation's endowment; donor-advised funds and supporting organizations do not have to meet a minimum payout.

Private foundation	A 501(c)(3) organization, further defined in IRC section 509(a), that does not qualify as a public charity. Generally, private foundation rules and regulations are more complex and limiting than those for public charities.
Private benefit	The transfer or use of a charity's assets or income, or the conferment of undue advantage, to private persons who are not necessarily charity insiders. Some private benefit is permitted, but it must not be more than incidental to the charitable purpose being served. Private benefit is a broad term that includes inurement and applies to all 501(c)(3) organizations.
Public charity	A tax-exempt organization defined in IRC section 501(c)(3) that receives broad financial support or is a supporting organization. Public charities have fewer legal requirements than private foundations.
Revocation	A corrective action that removes a charity's tax-exempt charter. Revocation is used for violations such as inurement, performing nonexempt activities, operating in a commercial manner, and operating for private use.
Section 501(c)(3) organization	A tax-exempt organization operated for a charitable purpose. Purposes considered to be charitable include serving the poor and distressed; advancing religious, educational, or scientific endeavors; and protecting human or civil rights. All 501(c)(3) organizations are considered either public charities or private charities, known as private foundations. Contributions to charities are tax deductible under IRC section 170.
Self-dealing	Transactions, either direct or indirect, made between a private foundation and disqualified person that involve (1) sale, exchange, or lease of property; (2) lending of money or other extensions of credit; (3) providing goods, services, or facilities; (4) paying compensation to or reimbursing expenses of a disqualified person; (5) transferring foundation income or assets to, or for the use or benefit of, a disqualified person; and (6) certain agreements to make payments of money or property to government officials.

Supported organization	A tax-exempt organization that receives funds or services from a supporting organization.
Supporting organization	A public charity defined under IRC section 509(a)(3) that provides money or services to one or more supported organizations. There are three types of supporting organizations defined by their relationship with their supported organization(s):
Type I	operated, supervised, or controlled by a supported organization (parent–subsidiary relationship);
Type II	supervised or controlled in connection with the supporting organization (brother-sister relationship); and
Type III	operated in connection with the supported organization(s).

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