Taking On One of the "Dirty Dozen" Tax Scams

By Kristina C. Moore

In July 2006, the National Committee for Responsive Philanthropy helped break the news about questionable practices by Health and Human Services Secretary Michael Leavitt's family foundation, the Dixie and Anne Leavitt Foundation.[1] The tremendous media coverage the story generated brought long-overdue attention to the loopholes that surround Type III supporting organizations, which along with donor-advised funds, are on the IRS' list of "dirty dozen" tax scams.

As a result, Sen. Charles Grassley (R-Iowa), then chairman of the Senate Finance Committee, with a track record of actively championing charitable accountability, included a number of provisions to close some of these loopholes in a piece of legislation, which was designed to reduce abuses by nonprofits and donors. President George W. Bush signed the Pension Protection Act into law in August 2006.

The Pension Protection Act of 2006 (PPA) included a provision requiring the Department of the Treasury and the IRS to study donor-advised funds and supporting organizations. NCRP submitted its comments to the Treasury and the IRS in April 2007, wherein it listed disclosure, payout requirements and opportunities for misconduct as immediate issues that the government needed to address. These loopholes in the current system allow for mismanagement, illegal activities and rampant abuse.

DONOR-ADVISED FUNDS

Donor-advised funds attract donors who want some of the benefits of a private foundation without the bureaucratic obligations. The funds provide donors with the opportunity to make recommendations for how their contributions will be used, but are controlled and administered by community foundations, universities, hospitals, the United Way or similar institutions for a fee.

There had been no specific definition for donor-advised funds prior to the PPA, and public charities are not required to report on the assets and distributions of these funds. In its comments, NCRP described why nonprofits, lawmakers and regulators should find this lack of available information troubling:

> This constitutes a world of hidden philanthropy that merits significantly upgraded disclosure—by donor-advised funds—of assets and how these assets are invested and distributed. While donors are not supposed to exercise binding control over the managing charities' distributions from their funds, it is widely known in the field that "donor-advised" is, in many instances, a euphemism for "donor-controlled" or "-mandated". Until

Unfortunately, we cannot effectively regulate that which we do not know or understand. Although some may say that ignorance is bliss, in this instance it is our duty to become wise.

Photo by Tim Sloan, AFP/Getty Images

Surrounded by Congressmen, US President George W. Bush signs the Pension Protection Act of 2006, 17 August.

there is reporting and disclosure for each donor-advised fund, there will be no adequate way for the IRS to determine with any certainty that the donors' advice and direction is truly non-binding, that the managers of these funds are performing adequate due diligence, and that charitable purposes are being pursued through the distributions.[2]

This lack of disclosure means that what we do know about donor-advised funds reveals only a small part the full picture; the exact number of funds, their assets and distribution are largely unknown. Unfortunately, we cannot effectively regulate that which we do not know or understand. Although some may say that ignorance is bliss, in this instance it is our duty to become wise.

SUPPORTING ORGANIZATIONS

In 2002, 2003 and 2004, the Leavitt Foundation—a Type III supporting organization—donated less than 1 percent of its $9 million assets, while family members claimed millions of dollars in tax deductions for their contributions to the foundation. The Washington Post reported that most of the foundation money had been invested in or lent to family interests and holdings. As a Type III supporting organization, the Foundation is not subject to the 5 percent payout requirement of private foundations.

According to the General Accountability Office, over 21,000 supporting organizations filed tax returns in 2003.[3] Defining, identifying and classifying these organizations are daunting tasks, even to experts, and therein lies the danger:

> The complexities of the definitional tests (i.e., responsiveness, integral part, and control) have been reviewed in the literature to reveal just how impenetrable the supporting organization is to most observers. When the mechanisms for charity and philanthropy are as technical and arcane as to defy general understanding, what can be understood is that there are great opportunities for misuse and abuse.[4]

DONOR-ADVISED FUNDS

According to the Pension Protection Act of 2006, donor-advised funds must have the following characteristics:

- These funds are separately identified by reference to contributions of a donor or donors;
- These funds are owned and controlled by a sponsoring organization; and,
- Donors (or any other person appointed by the donors) have, or must reasonably expect to have, the privilege of providing advice regarding the funds' distribution and investments.

Sponsoring organizations of donor-advised funds are public charities such as community foundations, hospitals, universities and the United Way.

SUPPORTING ORGANIZATIONS

A supporting organization is a 501(c)(3) organization that qualifies as a public charity because of its close relationship with another publicly supported 501(c)(3) organization. A supporting organization must provide financial and/or programmatic support to a beneficiary organization. The beneficiary organization also exercises a certain level of operational control over the supporting organization.

There are three types of supporting organizations, and classification is determined by the relationship between the donor and beneficiary organizations:

- Type I: the beneficiary organization appoints the majority of the governing board members of the supporting organization.
- Type II: at least a majority of the beneficiary organization's board members are also members of the supporting organization's board.
- Type III: the two organizations are each more independent; the beneficiary organization usually appoints one member of the supporting organization's governing board. Type III organizations may choose to carry out a program or function of the beneficiary organization, instead of providing financial support.

There are currently three types of supporting organizations, which are based on the level of control the beneficiary exercises over the donor organization. In its comments, NCRP urged the IRS and the Treasury to consider the full disclosure of grants and distributions for all supporting organizations and the elimination of Type III supporting organizations where the "likelihood for abuse is the greatest."

> When the mechanisms for charity and philanthropy are as technical and arcane as to defy general understanding, what can be understood is that there are great opportunities for misuse and abuse.

MORE NEEDS TO BE DONE

There are two other reforms that NCRP recommends that the Treasury, the IRS and Congress should seriously consider. First, donor-advised funds and supporting organizations should all be subjected to the same payout requirements as private foundations.

The current payout rate for private foundations is 5 percent, which can include administrative costs. NCRP has historically called for Congress to increase this annual minimum qualifying distribution to 6 percent—excluding overhead expenses—as a way to get much-needed philanthropic dollars in the hands of grantee organizations.

"With less overhead, less 'process' to their grantmaking and a comparatively low administrative 'load' charged by their fund managers, donor-advised funds should easily be able to make a 6 percent payout for each individual fund as well as cumulatively," NCRP noted in its comments. "Using supporting organizations to warehouse charitable funds does not further the interests of the nonprofit sector or the public at large."[5]

Finally, since donor-advised funds and supporting organizations operate as the equivalent of foundations that accumulate billions of tax-exempt funds, both charitable instruments should be subjected to excise tax payments. Proceeds from the tax should be allocated to support oversight and enforcement efforts by the IRS and state regulators.

The recommendations for donor-advised funds are based on the understanding that most of the donors who use this charitable giving tool are individuals of financial means. But what about funds used by donors of limited means out of a sincere effort to help lift their struggling communities?

Because of the unique needs and limited resources available to these communities and their donors, there is room for exceptions that would help prevent these recommendations from hurting vulnerable but valuable local efforts without sacrificing standards for the majority of donor-advised funds.

The Pension Protection Act of 2006 (PPA) is a step in the right direction, but there are still a number of outstanding issues that legislators and regulators need to address. In its role as the nation's premier philanthropic

THE IRS LIST OF DIRTY DOZEN TAX SCAMS IN 2006

1. Zero Wages
2. Form 843 Tax Abatement
3. Phishing
4. Zero Return
5. Trust Misuse
6. Frivolous Arguments
7. Return Preparer Fraud
8. Credit Counseling Agencies
9. **Abuse of Charitable Organizations and Deductions, such as involving supporting organizations, donor-advised funds, and historic façade easement contributions**
10. Offshore Transactions
11. Employment Tax Evasion
12. "No Gain" Deduction

Note: The list, which includes a full description of each item, is available on the IRS website: http://www.irs.gov/newsroom/article/0,,id=154293,00.html.

watchdog, NCRP will continue to promote transparency while seeking to eliminate potential breeding grounds of philanthropic abuse.

Kristina C. Moore is communications associate at NCRP.

You can download the full text of *Protecting the Public Interest: Recommendation for Donor-Advised Funds and Supporting Organizations* from www.ncrp.org.

Do you agree with NCRP's recommendations to reform donor-advised funds and supporting organizations? Share your thoughts! Join the conversation on NCRP's blog at www.ncrp.org/blog.

NOTES

1. Jonathan Weisman, "HHS Secretary's Fund Gave Little to Charity," *The Washington Post*, July 21, 2006.
2. NCRP, "Protecting the Public Interest: Recommendations on Donor-Advised Funds and Supporting Organizations" (Comments submitted to the IRS and the Department of the Treasury on April 19, 2006), http://www.ncrp.org/downloads/Statements/NCRP_DAF_SO_Comments_040907.pdf.
3. U.S. GAO, *Tax Exempt Organizations: Collecting More Data on Donor-Advised Funds and Supporting Organizations Could Help Address Compliance Challenges*, July 2006. p.19.
4. NCRP, op. cit. p. 4.
5. NCRP, op. cit. pp. 3, 5.
6. Barton, Noelle, "How the Survey of Donor-Advised Funds Was Conducted," *Chronicle of Philanthropy*, May 3, 2007.

DONER-ADVISED FUNDS' INCREASING POPULARITY

The Chronicle of Philanthropy's most recent survey of 102 gift funds, community foundations and other nonprofits that administer donor-advised funds noted the over 100,000 funds in operation in 2005 to 2006, 11 percent more than the previous year's survey. There was also an increase in asset value of about 21 percent to $19.2 billion.[6]

SOME PROVIDERS OF DONOR-ADVISED FUNDS BY ASSETS IN 2006

	Type of Institution	2006 Assets ($)	2006 Charitable Distributions ($)	Number of Funds
Fidelity Charitable Gift Fund	Commercial Fund	3,533,952,375	931,777,589	36,693
Vanguard Charitable Endowment Program	Commercial Fund	1,202,141,223	300,262,906	5,363
Schwab Fund for Charitable Giving	Commercial Fund	1,029,509,544	166,593,224	7,901
National Christian Foundation	Religious Fund	836,108,250	229,319,416	4,493
New York Community Trust	Community Foundation	750,651,554	98,779,863	1,004
Jewish Communal Fund	Religious Fund	723,481,326	218,370,505	2,298
Greater Kansas City Community Foundation	Community Foundation	449,718,612	69,883,227	753
Harvard University	College/University	151,000,000	6,800	29
Tides Foundation	Social Justice Fund	128,501,876	50,262,299	280
Cornell University	College/University	33,426,000	4,899,834	96
Funding Exchange	Social Justice Fund	14,217,000	2,308,000	71

Source: *Chronicle of Philanthropy*, 3 May 2007.