Treasury Releases Proposed Donor Advised Fund Regulations Addressing Taxable Distributions and Key Definitions

Following more than 15 years of anticipation, Treasury and the IRS have issued proposed regulations interpreting certain Internal Revenue Code (Code) provisions applicable to donor advised funds (DAFs). A popular charitable giving technique that has grown exponentially in recent years, a DAF is an account maintained by a charitable organization (a "sponsoring organization") to which donors may make deductible contributions and thereafter make recommendations regarding charitable grants from and the investment of the assets in the account.

The proposed regulations provide guidance on only the taxable distribution provisions applicable to DAFs under Code Section 4966, which impose excise taxes on certain prohibited distributions by DAFs. As a result, taxpayers must continue to await further guidance addressing other long-standing questions. Such questions include the impact of DAF distributions on a public charity grantee's tax-exempt status, the tax treatment of grants by private foundations to DAFs, and confirmation of the rules applicable to DAF distributions used to satisfy binding pledges. The taxable distribution provisions contain the fundamental definitions applicable to DAFs, however. The proposed regulations thus provide some insights into the operation of certain other DAF rules. In addition, they provide technical guidance implementing the prohibition on taxable distributions, and sponsoring organizations and donors will need to understand this guidance to ensure they do not inadvertently violate the rules.

Key take-aways include the following:

- **The proposed regulations provide expansive definitions of the terms "donor advised fund," "donor-advisor," and "taxable distribution."** Overall, the proposed regulations reflect concern that taxpayers could structure funds to sidestep the DAF rules when it would be advantageous. They include provisions designed to ensure that funds that are, in substance, DAFs are captured by the rules. Certain funds that have not historically been considered DAFs might, therefore, be treated as DAFs under the rules and subject to the special restrictions that apply to DAFs. Charitable organizations that maintain endowment or other funds will need to consider whether the rules could reach them unexpectedly.

- Charitable organizations, particularly including community foundations, often provide donors with an opportunity to impact the ongoing administration of a fund by participating on an advisory committee that makes recommendations regarding the fund's distributions or investments. A donor, donor-advisor, or related person (as defined in the proposed regulations) who serves on such an advisory committee, as well as any committee member who was recommended to serve on such a committee by a donor or donor-advisor, will be treated as having advisory privileges with respect to the fund unless strict requirements are satisfied. **As a result, individual grantmaking, field of interest, and other funds with advisory committees will be particularly more likely to be captured as DAFs. Organizations that permit donors to establish funds with advisory committees will therefore need to take care when structuring the funds, especially if a fund's classification as a DAF would inhibit its purpose.**

- Many DAF programs permit investment advisors to help manage the assets in their clients' DAFs, and the advisors may therefore provide investment advice with respect to both the assets maintained in a donor's DAF and the donor's personal assets. The regulations propose to treat an investment advisor serving such dual roles as a donor-advisor of a donor's DAF, regardless of whether the advisor is formally appointed to such position, unless the advisor is properly viewed as providing services to the sponsoring organization as a whole (rather than the particular DAF). **If finalized in their current form, the proposed regulations will therefore largely restrict DAFs from compensating donors' personal investment advisors. This rule will have a significant impact on DAF programs whose business models involve such fee arrangements.** The preamble to the proposed regulations explains that Treasury and the IRS are concerned that these arrangements may create conflicts of interest and may result in a donor's personal investment advisor receiving prohibited benefits.

- The Code imposes a 20% excise tax on a sponsoring organization that makes a taxable distribution from a DAF and a 5% excise tax on any fund manager who knowingly agrees to the distribution. **Treasury and the IRS rejected requests to construe the term "distribution" narrowly as including only gratuitous transfers. Rather, any payment from a DAF – other than most investments and reasonable investment and grant-related fees – will potentially be subject to, and will therefore need to comply with, the taxable distribution rules.**

Treasury and the IRS are accepting comments on the proposed regulations until January 16, 2024. As currently drafted, the regulations will be effective for taxable years ending on or after the date they are finalized. If the regulations are finalized in the middle of an organization's tax year, they will therefore have retroactive application to the beginning of the tax year unless the effective date is changed. While the final regulations will likely differ in certain respects from the proposed regulations, charitable organizations should begin considering how the regulations may impact their operations.

For additional details regarding key provisions in the proposed regulations, please continue reading below.

Definition of "Donor Advised Fund"

The proposed regulations provide significant detail regarding the meaning of the term "donor advised fund." The Code defines a DAF as a fund or account (i) that is separately identified by reference to contributions of one or more donors, (ii) that is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor or person designated by such donor has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund by reason of the donor's status as a donor. The proposed regulations provide detailed guidance on these components, including the following:

When is a fund separately identified by reference to the contributions of one or more donors?

- A fund will be treated as separately identified by reference to the contributions of one or more donors if the sponsoring organization maintains a formal record of contributions to the fund relating to a donor or donors. However, a fund may be treated as a DAF even in the absence of a formal record if certain facts and circumstances set forth in the proposed regulations demonstrate that it is, in fact, separately identified.

- The proposed regulations exclude most public charities from the definition of "donor." A fund whose only donor-advisors are public charities will therefore not ordinarily constitute a DAF, even if the fund receives contributions from other types of donors as well. On the other hand, Treasury and the IRS explicitly rejected a proposal to exclude private foundations and disqualified supporting organizations (as defined in Code Section 4966 and the proposed regulations) as donors, reasoning that such organizations could use a DAF to circumvent payout and other legal requirements.

When does a donor or donor-advisor have advisory privileges by reason of the donor's status as a donor?

- Treasury and the IRS rejected requests to define advisory privileges narrowly. Instead, the proposed regulations set forth several circumstances in which a donor or donor-advisor will be treated as having advisory privileges by reason of the donor's status as a donor, regardless of whether the donor or donor-advisor actually exercises such privileges. For example, a donor or donor-advisor will be treated as having advisory privileges by reason of the donor's status as a donor if the sponsoring organization "allows a donor or donor-advisor to provide nonbinding recommendations" or "generally solicits advice from a donor or donor-advisor" regarding the distribution or investment of amounts held in a fund or account." This prong could therefore potentially capture funds that offer ongoing engagement by donors or others and that have not historically been thought of as DAFs. Whether advisory privileges exist will otherwise generally depend on the facts and circumstances. Importantly, advisory privileges may exist even if a donor or donor-advisor does not actually provide any advice with respect to a fund.

- The preamble to the proposed regulations expressly confirms that a gift restriction should not give rise to advisory privileges if it is placed on a gift when it is made and there is no provision for subsequent discretion regarding the restriction. However, Treasury and the IRS otherwise declined to provide guidance regarding when a donor's legally enforceable right might be treated as resulting in advisory privileges, leaving open the possibility that a gift restriction related to a fund could possibly cause the fund to be treated as a DAF.

What funds are excepted from the definition of a DAF?

- **Funds supporting a single identified organization.** Consistent with the Code, a fund will not be treated as a DAF if it is established to make distributions only to a single identified organization. To qualify under this exception, the "single identified organization" must be either a U.S. public charity (other than a disqualified supporting organization) or a governmental entity that receives distributions from the fund exclusively for public purposes. This exception will therefore be unavailable to a fund that makes distributions to a private foundation, disqualified supporting organization, foreign organization, or non-charitable entity. In addition, the fund must make all distributions directly to the single identified organization, and the organization may not use the distributions to make grants or administer DAFs. The exception will not be available to a fund if (i) a donor, donor-advisor, or related person has or reasonably expects to have the ability to advise regarding distributions from the organization to other individuals or entities (e.g., as a director or trustee of the organization), or (ii) a distribution from the fund would provide, directly or indirectly, a more than incidental benefit to a donor, donor-advisor, or related person with respect to the fund. The term "more than incidental benefit" remains to be defined by future guidance, as this term appears under a different Code provision.

- **Scholarship and disaster relief funds.** The proposed regulations provide additional guidance on a Code provision that excepts from the definition of a DAF a fund that makes grants exclusively for travel, study, or other similar purposes, so long as certain requirements are met. Expanding prior IRS guidance, the proposed regulations also except from the DAF rules both employer-sponsored and non-employment-based disaster relief funds that satisfy certain requirements. However, Treasury and the IRS declined to extend this exception more broadly to emergency hardship funds. In addition, the proposed regulations add a new exception for certain scholarship funds established by a Code Section 501(c)(4) social welfare organization with a broad-based membership.

Definition of "Donor-Advisor"

- Like other terms, the proposed regulations define the term "donor-advisor" broadly. The term appears in all of the DAF rules, including in provisions that prohibit DAFs from being used to provide compensation or to make payments to donors, donor-advisors, and related persons. As a result, the term will have a far reach.

- In addition to the specific rules mentioned above regarding personal investment advisors and advisory committee members, the proposed regulations provide that a donor-advisor includes any person appointed or designated by a donor or a donor-advisor to have advisory privileges regarding the distribution or investment of assets held in a fund. In either case, no particular form of appointment is necessary. As a result, an organization will need to look beyond the people formally designated as donor-advisors (on, e.g., DAF application forms) to ensure they are properly identifying all donor-advisors.

Definition of "Taxable Distributions"

Subject to certain exceptions, a "taxable distribution" includes a distribution to (i) an individual or (ii) any other person if the distribution is not for charitable or other exempt purposes or the sponsoring organization does not exercise so-called expenditure responsibility with respect to the distribution.

When is a payment from a DAF considered a "distribution"?

- As noted above, Treasury and the IRS rejected proposals to define the term "distribution" as including only gratuitous transfers. Instead, the proposed regulations define the term broadly as generally including any grant, payment, disbursement, or transfer, whether in cash or in kind, from a DAF.

- Investments as well as reasonable investment and grant-related fees will not generally be treated as distributions, and therefore will not be subject to the taxable distribution rules. However, the preamble to the proposed regulations states that a zero-interest loan, or other investment that does not have the purpose of providing income, will be treated as a distribution. Such expenditures will therefore be taxable distributions unless made to a qualified charitable organization or the sponsoring organization exercises expenditure responsibility. Of note, this rule is inconsistent with the rules that apply to private foundations making so-called program related investments. We expect that it may therefore generate questions from, and could result in foot faults by, donors who use both DAFs and private foundations to make impact investments.

- An expense charged solely to a particular DAF that is paid, directly or indirectly, to a donor, donor-advisor, or related person of the DAF will be a deemed distribution and therefore potentially prohibited by the taxable distribution and other DAF rules. The preamble to the proposed regulations indicates that an expense charged uniformly or ratably across all of a sponsoring organization's DAFs should generally be treated as a grant-related fee and not a distribution. However, the term "indirectly" is not defined and so its precise meaning is unclear.

- Any use of DAF assets that results in a "more than incidental benefit" to a donor, donor-advisor, or related person will be treated as a deemed distribution and will therefore generally be a taxable distribution. A separate Code provision prohibits a DAF from being used to provide a more than incidental benefit to a donor, donor-advisor, or related person of the DAF. The preamble to the proposed regulations indicates that such deemed distributions could therefore be subject to excise taxes under both those and the taxable distribution rules. The proposed regulations leave some open questions, though, such as how precisely the tax will be calculated under the taxable distribution rules.

- Under an anti-abuse rule, a series of distributions pursuant to a plan will be treated as a single distribution if the plan achieves a result inconsistent with the purposes of the taxable distribution rules. The preamble to the proposed regulations explains that this rule would apply, for example, if a sponsoring organization makes a DAF distribution to a charity and the donor to the DAF subsequently arranges for the charity to use the funds to make a distribution that would be a taxable distribution if made by the DAF directly. This rule could therefore result in a sponsoring organization making a taxable distribution, and being liable for excise tax, because of actions taken by a donor or grantee unbeknownst to the sponsoring organization. If this provision is enacted in its proposed form, sponsoring organizations may wish to implement procedures to protect themselves from the unexpected application of this rule.

What distributions are excepted from the taxable distribution rules?

- A taxable distribution does not include a distribution to an organization described in Code Section 170(b)(1)(A) (other than a disqualified supporting organization), the sponsoring organization of a DAF, or any other DAF. The proposed regulations provide guidance regarding the types of organizations that qualify as described in Code Section 170(b)(1)(A), as well as the meaning of a disqualified supporting organization. In particular, the proposed regulations confirm that a foreign charitable organization may qualify under this rule, so long as the sponsoring organization makes a good faith determination that the foreign organization is equivalent to a qualified U.S. tax-exempt organization. Sponsoring organizations may use the same equivalency determination rules for this purpose as apply to private foundation grantors. Otherwise, the expenditure responsibility rules, discussed below, will apply.

When does a DAF distribution qualify as made for charitable or other exempt purposes?

- A distribution will not be considered made for charitable or other exempt purposes if it is used for an activity that is prohibited under Code Section 501(c)(3) or that would cause loss of tax exemption if it were a substantial part of a Code Section 501(c)(3) organization's total activities. Thus, for example, distributions used for lobbying will not be considered made for exempt purposes, even though charitable organizations may engage in some lobbying activities.

How do the expenditure responsibility rules apply to DAF distributions?

- Under the taxable distribution rules, a sponsoring organization must exercise so-called expenditure responsibility with respect to any distribution to an entity other than a Code Section 170(b)(1)(A) organization. These rules generally require that a grantor perform certain diligence on a proposed grantee, enter into a grant agreement with the grantee containing certain terms, and obtain reports from the grantee. The proposed regulations confirm that the private foundation expenditure responsibility rules apply for this purpose, with one substantive modification. The rules that apply to private foundations require that grantees agree to use grant funds in a manner consistent with the private foundation rules. The proposed regulations instead require compliance with the DAF rules. The proposed regulations also import a rule from the private foundation context requiring that a grantee, where it is not a Code Section 501(c)(3) organization, separately account for a DAF grant on its books or else segregate the grant funds in a separate account.

Taxation of Taxable Distributions

The proposed regulations address how to calculate the excise taxes applicable to taxable distributions. The proposed rules are generally similar to the provisions that apply to other excise taxes applicable to charitable organizations.

In particular, the proposed regulations provide additional guidance regarding the excise tax applicable to fund managers who knowingly agree to a taxable distribution. Echoing the Code, the proposed regulations define a fund manager as an officer, director, or trustee of a sponsoring organization, or any individual with similar authorities or responsibilities, as well as certain employees. Of note, fund managers may also potentially include outside investment managers, or other service providers, in certain instances.

We will continue to monitor these and other developments relating to DAFs and charitable giving more broadly, in the meantime we invite you to reach out to a member of your Choate team for guidance.

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