**Nonprofits & Tax-Exempt Organizations Alert**

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# Proposed Regulations on Donor-Advised Funds– Part I of the Anticipated Guidance: What Qualifies and What Doesn't

Seventeen years after the enactment of the Pension Protection Act, the Internal Revenue Service (IRS) and the U.S. Treasury Department (Treasury) have published their first installment of proposed regulations interpreting the federal tax provisions governing donor-advised funds (DAFs). The Proposed Regulations provide interpretive guidance under Section 4966 of the Internal Revenue Code of 1986, as amended, related to excise taxes on certain distributions from DAFs. These Proposed Regulations, in large part, affirm interim IRS guidance released in several IRS notices over the years, and also address numerous taxpayer comments. Most notably, the Proposed Regulations offer clear (though broad) definitions of a DAF, a "donor," a "donor-advisor" and a "distribution" for purposes of Section 4966.

Donors will have to keep waiting for guidance on a number of outstanding questions regarding the administration and regulation of DAFs, such as:

- What constitutes a prohibited benefit under IRC Section 4967.
- Application of the excess benefit transaction rules under Section 4958.
- Tax treatment of DAF distributions for purposes of a charity's public support computation under Section 509(a).

All of these regulation projects remain in the IRS's 2023-2024 Priority Guidance Plan.

The Proposed Regulations will become effective only for tax years ending after the date when they are published as final regulations in the *Federal Register*. Any comments on the Proposed Regulations are due by Jan. 16, 2024.

## Background and Important Definitions

Since 2006, DAFs have been defined under Section 4966(d)(2)(A) as a fund or account (i) that is **separately identified** by reference to contributions of a donor(s), (ii) that is owned and controlled by a **sponsoring organization** (a public charity), and (iii) with respect to which a donor (or any person appointed or designated by the donor, namely a **donor-advisor**) has or reasonably expects to have **advisory privileges** with respect to the distribution or investment of amounts held in the fund or account by reason of the donor's status as a donor.

DAFs do not include funds or accounts that make distributions only to a single identified organization or governmental entity, or funds or accounts that only provide scholarship funds.

All section references hereinafter made are to the Internal Revenue Code of 1986, as amended.

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Certain distributions from DAFs are subject to a 20% excise tax under Section 4966(a)(1) (referred to as "taxable distributions"). The excise tax is payable by the DAF's sponsoring organization, but Section 4966(a)(2) also imposes a 5% excise tax on a fund manager (individuals at the sponsoring organization managing the DAF distributions) who agrees to make a DAF distribution knowing that it's a taxable distribution.

## What's New?

The Proposed Regulations provide guidance to help determine whether a DAF exists and when a taxable distribution may occur. In both cases, the guidance broadens the concepts, adding facts and circumstances analyses where they did not necessarily exist before.

For starters, the Proposed Regulations would expand three key elements in the definition of a DAF under Section 4966:

- **Separately Identified**

  A fund will be treated as a DAF only if it is **separately identified** by reference to contributions from one or more donors. Prior to the Proposed Regulations, it was assumed that if a fund did not reference the names of donors, it would not qualify as a DAF, even if those donors had advisory privileges. However, the Proposed Regulations now make this a possibility. While the Proposed Regulations refer to a "separately identified" account as arising where the sponsoring organization keeps a "formal record" of contributions made by a donor, the lack of a formal record would not necessarily mean that an account is not a DAF. Instead, a facts and circumstances test would apply, with the following factors tending to show that a fund is separately identified: (i) the fund balance reflects items such as contributions, dividends, interest, distributions, administrative expenses, and gains and losses; (ii) the fund is named after one or more donors, donor-advisors or related persons; (iii) the sponsoring organization refers to the fund as a DAF or has an agreement with donors or donor-advisors that it is a DAF; (iv) one or more donors or donor-advisors regularly receive a fund statement from the sponsoring organization; or (v) the sponsoring organization generally solicits advice from the donors or donor-advisors.

- **Advisory Privileges**

  Under the Proposed Regulations, the determination of advisory privileges would also be based on a broader analysis of facts and circumstances. Any of the following factors would be sufficient to establish that a donor or donor-advisor has advisory privileges, **regardless of whether the donor or donor-advisor actually exercises such rights:** (i) the sponsoring organization allows a donor or donor-advisor to provide nonbinding recommendations regarding distributions or investments, (ii) a written agreement between the sponsoring organization and the donor or donor-advisor states that they have advisory privileges, (iii) documents or marketing materials indicate that a donor or donor-advisor may provide advice or (iv) the sponsoring organization generally solicits advice from a donor or donor-advisor.

  Under this approach, a restricted gift agreement might inadvertently create a DAF if the donor can provide input after the date of the gift or even if the donor retains approval or veto powers. A donor's upfront restrictions without subsequent discretion would not give rise to creating a DAF, but the mere expectation of future advisory rights could create that privilege (regardless of whether those rights are exercised). Treasury and the IRS have requested comments regarding application of the definition of advisory privileges in these circumstances.

  The Proposed Regulations also provide that service on a committee that advises on distributions or investments of a fund or account would constitute a form of advisory privilege, even when the sponsoring organization controls the selection of committee members consistent with its required ownership and control. However, the Proposed Regulations outline two special exceptions, including an exception where members of an advisory committee are recommended by a donor or donor-advisor and (1) the recommendation is based on objective criteria related to the member's expertise; (2) the committee consists of three or more individuals, a majority of whom are not recommended by the donor; and (3) the member is not a related person with respect to the recommending donor.

- **Donors or Donor-Advisors**

  Under the Proposed Regulations, a donor would be defined as all persons, including organizations, under Section 7701(a)(1) that contribute to a fund or account of a sponsoring organization, but it would explicitly exclude from the definition of "donor" (1) any public charity other than a disqualified supporting organization described in Section 509(a)(1), (2) or (3) and (2) any governmental unit described in Section 170(c)(1). A donor-advisor would include any person appointed or designated by a donor to have advisory privileges regarding the distribution or investment of assets held in a fund or an account of a sponsoring organization.

  The sponsoring organization's hiring of a donor's personal investment advisor to manage the investment of funds in that donor's DAF account may trigger taxable distribution concerns. Under the Proposed Regulations, an investment advisor—as defined in Section 4958(f)(8)(B)—who is also the donor's personal investment manager would be considered a donor-advisor if the donor recommends that advisor as the investment manager of their fund or account at a sponsoring organization. This new rule is significant because a donor-advisor's receipt of compensation from a DAF would be treated as an automatic excess benefit transaction under Section 4958(c)(2).

The expanded definitions above may have unintended consequences for certain types of funds that had traditionally not been treated as DAFs:

- **Foundation-supported collaborative funds and similar types of funds could be DAFs.** Due to the broader definition of "separately identified," clarification that a fund or account at a sponsoring organization that receives donations from multiple sources/donors could constitute a DAF, and the fact that mere service on an advisory committee would create advisory privileges, certain foundation-supported collaborative funds and other similar types of funds could trigger DAF treatment. Treasury and the IRS requested comments on exceptions to this scenario, and the exceptions to the definition of an advisory committee are useful to consider in the interim. There would not be an impact on public charities and governmental entities contributing to these funds, as these types of entities would be exempt from the definition of a donor.
- **"Friends of" funds may now be DAFs.** Many foreign organizations establish U.S. affiliate charities in the hope of attracting donations from U.S. taxpayers. These "American friends of" projects are sometimes organized as a fund or account hosted by a U.S. public charity. This structure has not traditionally been viewed as a DAF if the fund makes distributions to a single organization. However, under the Proposed Regulations, this exception would not apply if the single DAF distribution recipient is a private foundation, disqualified supporting organization, **foreign organization** or noncharitable organization. The Proposed Regulations currently do not allow for an expansion of this exception where the single foreign organization has an equivalency determination.

The Proposed Regulations would also expand the definition of a taxable distribution. Section 4966(c)(1) defines "taxable distribution" to include any distribution from a DAF to any natural person if (1) the distribution is for any purpose other than a purpose specified in Section 170(c)(2)(B) or (2) the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with Section 4945(h).

- **The Proposed Regulations clarify that the definition of "distribution" is broader than many in the sector anticipated.** Section 4966(c)(1) imposes an excise tax on certain distributions from DAFs, which are defined broadly to include a grant, payment, disbursement or transfer from a DAF. The only real carve-outs from the definition would be investments as well as reasonable investment or grant-related fees.
- **Step transaction principles apply.** Despite requests that the term "distributions" be narrowly defined, the Proposed Regulations would set forth an anti-abuse rule providing that if a series of distributions, stepped together, would create a taxable distribution as the end result, then the distributions would be treated as a single distribution for purposes of Section 4966.
- **Distributions from DAFs to individuals continue to be disallowed, and the Proposed Regulations clarify the exceptions:**
  - **Scholarship funds.** Section 4966(d)(2)(B)(ii) excludes from the definition of DAFs a fund or account that only provides scholarships, fellowships or other grants to individuals, as described in Section 4945(g). The Proposed Regulations add a facts and circumstances

analysis to ensure that donors and donor-advisors are not directly or indirectly in control of a selection committee for these types of funds. The Proposed Regulations also provide that a selection committee may be controlled by a donor-advisor that is a Section 501(c)(4) organization.

- **Disaster relief funds.** Consistent with Notice 2006-109, the Proposed Regulations would hold that an employer-sponsored disaster relief fund is not a DAF so long as the requirements of Section 139 (defining "qualified disaster relief payments") are met. The Proposed Regulations would not expand this exception to include hardship funds.

Given the breadth of the guidance provided, it is likely that the application of the Proposed Regulations would have consequences for a number of individuals and organizations that have not traditionally worried about whether a particular arrangement constituted a DAF.

For example, more funds and accounts may be swept in under the definition of a DAF, and more payments from a DAF may be treated as a taxable distribution. Taxpayers are encouraged to submit comments to the IRS and the Treasury to highlight these circumstances in advance of final regulations. We are standing by to help clients analyze these consequences, and we are happy to help draft comments in response.

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