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Treasury Releases First Installment of Long-Awaited Guidance on Donor-Advised Funds



Over the past several years, the U.S. Department of the Treasury has been preparing guidance concerning donor-advised funds (DAFs), which are accounts owned and controlled by public charities over which individual or corporate donors may exercise advisory privileges.

In November, Treasury finally released the first of four pieces of guidance that it has told practitioners to expect. While this first release leaves some long-anticipated decisions for the future, it does offer helpful clarification, both for donors who may use DAFs as a philanthropic tool and for public charities that sponsor DAFs.

The first release consists of proposed regulations under Internal Revenue Code Section 4966, which plays two roles. First, it defines DAFs and DAF-sponsoring organizations. Second, it imposes a punitive excise tax on DAF-sponsoring organizations (and sometimes their individual managers) that make distributions from DAFs to impermissible recipients. The proposed regulations address both aspects of Section 4966, and the key provisions are summarized below.

Three more anticipated releases from Treasury are expected to include the following guidance:

- Under IRC Section 4967, imposing excise tax on distributions from DAFs that confer benefit on DAF donors or donor-advisors, their families, or their businesses.
- Under IRC Section 4958, imposing excise tax on so-called "excess benefit transactions" by public charities, specifically regarding excess benefit transactions involving DAFs.
- Concerning how contributions from DAFs to charities should be treated for purposes of the public support test for public charity status, set out in IRC Section 170(b)(1)(A)(vi).

Treasury has indicated that all of these releases should be arriving in the near future, but it has not provided a specific date for any of them.

Separately, DAFs continue to be a topic of interest in Congress. Members in both houses and of both parties have brought forward various proposals to reform DAFs, primarily in response to a policy concern that funds in DAFs do not reach operating charities in a timely way. The congressional proposals reach further than any guidance expected from Treasury, and some have the potential to limit sharply the usefulness of DAFs as philanthropic planning tools. None of them has passed through either house or appears likely to do so in the immediate future, but we will continue to track congressional developments.

Summary of Provisions

Definitions

The proposed regulations, following the Code, define a DAF as a fund or account (1) that is **separately identified** by reference to contributions of a donor or donors, (2) that is owned and controlled by a **sponsoring organization**, and (3) with respect to which at least one donor-advisor has, or reasonably expects to have, **advisory privileges** regarding the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

A fund or account is **separately identified** if the sponsoring organization maintains a formal record of contributions to the fund or account relating to a donor or donors, or under a facts and circumstances test looking to six factors, on which Treasury is seeking further comments. Governmental units and many public charities are excluded from the definition of "donor." But private foundations and most supporting organizations are not excluded, meaning that DAFs they establish will be subject to the same rules as DAFs established by individual donors.

A **sponsoring organization** is any organization that (1) is described in IRC Section 170(c) (other than a governmental organization and ignoring the requirement that it be created or organized in or under the laws of the United States, a state, or possession thereof); (2) is not a private foundation; and (3) maintains one or more DAFs.

The proposed regulations generally provide that the existence of **advisory privileges** depends on all the facts and circumstances, including the conduct of both the donor-advisor and the sponsoring organization, and any written agreement between them. A donor-advisor may have, or reasonably expect to have, advisory privileges even if the donor does not actually give advice.

Exclusions From DAF Status

The proposed regulations set out additional detail on two key exceptions from the Code's definition of "DAF": (1) funds that make distributions only to a single identified organization, and (2) funds (often called "scholarship funds") that make certain grants to individuals for travel, study, or similar purposes.

The proposed regulations also add two discretionary exceptions to the definition of "DAF": (1) funds dedicated for disaster relief, first signaled in Notice 2006-109; and (2) certain scholarship funds whose selection committee is nominated by a Section 501(c)(4) organization with a broad-based membership. These last two exceptions each require the fund to (a) have a single identified charitable purpose aligned with the particular exception, (b) use a selection committee subject to specific rules, and (c) award grants on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's board of directors. Public charities seeking to initiate funds of either type will likely wish to consult legal counsel in order to ensure that their grantmaking procedures are consistent with Treasury and Internal Revenue Service (IRS) requirements.

Taxable Distributions

Distributions by DAFs are taxable if they are made to impermissible recipients, including individuals, or if they may be used for noncharitable purposes. A tax of 20% of the taxable distribution may be imposed on the sponsoring organization, while a tax of 5% of the taxable distribution may be imposed on a manager of the DAF, personally, who **knowingly agreed** to the distribution.

The proposed regulations offer new guidance regarding what constitutes "agreement" and "knowledge" for a DAF fund manager. A fund manager will be considered to have agreed to a distribution through any manifestation of approval of the distribution that is sufficient to constitute an exercise of the manager's authority to approve. The manager acts with knowledge if they are, in fact, aware that the distribution is a taxable distribution or have knowledge of sufficient facts to determine that and negligently fail to make reasonable attempts to do so. Treasury has requested comments regarding whether reliance on professional advice may shield a fund manager from excise tax liability.

DAFs, like private foundations, must go through an "expenditure responsibility" process to grant funds to certain organizations, or those grants will be taxable distributions. The proposed regulations clarify that the universe of organizations to which DAFs may grant without expenditure responsibility is the same as it is for private foundations. Accordingly, DAFs may make grants to certain international organizations and to units of foreign governments without expenditure responsibility if the grants are exclusively for charitable purposes. DAFs may also use an equivalency determination process, as private foundations may, to determine that a grant to a foreign charity will not require expenditure responsibility.

Where a DAF grant does require expenditure responsibility, the proposed regulations provide that the required procedures are the same as those for private foundation grants, with one modification. Expenditure responsibility typically includes a written commitment from the grantee to use funds for charitable purposes. For expenditure responsibility grants from DAFs, this commitment also requires the grantee not to make a grant to any individual or to make any payment to certain persons related to the DAF, including its donors or donor-advisors.

Finally, the proposed regulations adopt an anti-abuse rule to prevent certain transactions designed to avoid taxable distributions. For example, if a donor advises a DAF to make a distribution to a public charity, and the donor or sponsoring organization subsequently arranges for the recipient charity to distribute the funds to an individual recommended by the donor, the distributions will be treated as a taxable distribution from the DAF sponsor to the individual.

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