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Tax-Exempt Organizations Alert
November 27, 2023

IRS Issues Proposed Regulations on Donor-Advised Funds

Since the enactment of the statutory donor-advised fund ("DAF") rules under the Pension Protection Act of 2006, sponsoring organizations that manage DAF programs have relied on the Internal Revenue Code ("IRC" or the "Code") and certain limited administrative guidance to structure and operate DAFs. On November 13, 2023, the Internal Revenue Service (the "IRS") issued Proposed Treasury Regulations (the "Proposed Regulations," REG-142338-07) that provide new guidance about how to interpret and apply IRC Section 4966, which imposes excise taxes on taxable distributions from a DAF as well as certain other tax rules related to DAFs. If adopted, the Proposed Regulations would, among other things, further define what constitutes a DAF, who is considered a "donor" and a "donor-advisor" with respect to a DAF, and what types of distributions from a DAF may subject a sponsoring organization and certain fund managers to excise taxes.

While the Proposed Regulations clarify certain aspects of the statute, they also add new definitions and concepts that could significantly impact how sponsoring organizations administer their DAF programs. This summary focuses on key questions the Proposed Regulations seek to answer.

The Treasury Department and the IRS are accepting comments on the Proposed Regulations until January 16, 2024. The Proposed Regulations will apply to taxable years ending after they are published as final regulations, although taxpayers have the option to rely on them immediately.

What is a DAF?

IRC Section 4966 defines a DAF as a fund or account (i) which is "separately identified by reference to contributions of a donor or donors," (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, "advisory privileges" with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

"Separately Identified"

The Proposed Regulations clarify that a fund or account is "separately identified by reference to contributions of a donor or donors" if the sponsoring organization maintains a formal record of contributions to the fund relating to a donor or donors.

In the absence of such a formal record, certain facts and circumstances are relevant to determining whether a fund is separately identified, including, for example, whether the fund is named after a donor, whether the donor regularly receives a fund statement, and whether the sponsoring organization generally solicits advice from the donor(s) or donor-advisor(s) before it makes distributions from the fund or account.

"Advisory Privileges"

The Proposed Regulations offer a facts and circumstances test for determining whether a donor has "advisory privileges" over the fund, regardless of whether such privileges are exercised.

Advisory privileges are deemed to exist if:

- the sponsoring organization allows the donor or donor-advisor to provide nonbinding recommendations regarding the distribution or investment of DAF assets;

- there is a written agreement stating that a donor or donor-advisor has such advisory privileges;

- a written document or marketing material of the sponsoring organization indicates that a donor may provide such advice; or

- the sponsoring organization generally solicits such advice from a donor or donor-advisor.

Advisory privileges can also arise from service on an advisory committee, subject to certain exceptions.

Key Observations

- *The Proposed Regulations interpret the statutory definition of a DAF broadly, adding factors intended to determine when a fund is "separately identified" and when advisory privileges exist, potentially capturing funds and arrangements that would not be considered DAFs under current guidance.*

- *Advisory privileges can inadvertently be created outside of a formal written agreement, such as when a sponsoring organization makes representations in marketing materials or provides a pre-approved list of investment options to donors, or in certain circumstances for individuals appointed to an advisory committee to the DAF.*

Who is a Donor and a Donor-Advisor?

Until now, DAF sponsoring organizations have been operating without a definition of donor or donor-advisor in the Code. The Proposed Regulations offer definitions of who is considered a "donor" and a "donor-advisor" with respect to a DAF. These definitions are relevant to determining whether a fund is a DAF, as well as determining who may be subject to excise taxes on taxable distributions under IRC Section 4966, prohibited benefits under IRC Section 4967, and/or excess benefit transactions under IRC Section 4958.

Donors

Under the Proposed Regulations, a "donor" is any person or entity that makes a contribution to a fund or account of a sponsoring organization. Notably, public charities described in IRC Section 509(a)(1), (2), or (3) (except certain disqualified supporting organizations) and governmental units described in IRC Section 170(c)(1) are not considered donors with respect to a DAF.

Donor Advisors

The Proposed Regulations define a "donor-advisor" in general as a person appointed or designated by a donor or another donor-advisor to have advisory privileges regarding the distribution or investment of assets held in a fund, or a person to whom a donor-advisor delegates advisory privileges.

Under the Proposed Regulations, a donor-advisor expressly includes:

- an investment advisor that provides investment management services with respect to both DAF and personal non-DAF assets of a donor, regardless of whether the donor appointed, designated, or recommended them (unless the personal investment advisor is "properly viewed" as providing services to the sponsoring organization "as a whole," rather than to a specific DAF);

- a person (other than a public charity or governmental unit) who establishes a fund and has advisory rights, regardless of whether they actually make contributions to the fund; and

- an advisory committee member recommended by a donor or donor-advisor and appointed by the sponsoring organization, unless certain requirements are met, including that the individual is recommended based on objective criteria with respect to the particular field of interest of the DAF.

Key Observations

- *The new definition of "donor" would appear to exclude from DAF status funds that are funded only by public charities and/or government units, as well as possibly excluding funds over which only public charities and/or government units have advisory rights.*

- *The new definition of "donor-advisor" would significantly impact sponsoring organizations that permit donors to recommend investment advisors to manage DAF assets in certain circumstances, particularly if those investment advisors also provide advice to donors and donor-advisors with respect to their personal assets. If the Proposed Regulations are adopted, any compensation or similar payments made from a DAF to pay an investment advisor that does not advise the sponsoring organization on all DAFs will need to be considered with respect to the tax on automatic excess benefit transactions under IRC Section 4958, the tax on "deemed distributions" under 4966, and the tax on prohibited benefits under IRC Section 4967.*

- *The expansive definition of donor-advisor also captures certain advisory committee members who may not have previously been thought of as donor-advisors.*

What is a Taxable Distribution from a DAF?

A "taxable distribution" under IRC Section 4966 means any "distribution" from a DAF (i) to any natural person or (ii) to any other person, if the distribution is for any purpose other than charitable purposes (as described in IRC Section 170(C)(2)(B)) or if the sponsoring organization does not exercise "expenditure responsibility" in accordance with IRC Section 4945(h), with certain modifications as described below.

The Proposed Regulations expand the statutory definition of a "distribution" (which includes any grant, payment, disbursement, or other transfer from a DAF) by introducing the concept of a "deemed distribution." A deemed distribution is any use of DAF assets that results in a more than incidental benefit (within the meaning of IRC Section 4967) to a donor, donor-advisor, or a related person as well as any expense charged solely to a DAF that is paid directly or indirectly to a donor, donor-advisor, or related person with respect to the DAF.

However, investments and reasonable grant-related or investment fees paid from a DAF would generally *not* be treated as distributions, unless they are "deemed distributions" (*i.e.*, they provide a more than incidental benefit to donors, donor advisors, or related persons).

The Proposed Regulations also provide the following:

- Distributions to organizations other than U.S. public charities will not be taxable distributions if the sponsoring organization either makes an "equivalency determination" ("ED") or exercises "expenditure responsibility" ("ER"), in each case in accordance with the procedures under IRC Section 4945, with some modifications in the case of ER.

- Under the Proposed Regulations, ER requires, among other things, the distributee to agree not to make a grant that does not comply with expenditure responsibility, a grant to a natural person, or a grant, loan, or compensation or similar payment to a donor, donor-advisor or related person.

- A distribution will not be considered made for charitable purposes when it is used for an activity which, if it were a substantial part of the grantee's activities, would put the grantee's tax-exempt status at risk, such as lobbying or political campaign activities.

Finally, the Proposed Regulations impose a special anti-abuse rule that allows the IRS to treat as a single distribution a series of distributions which together achieve results inconsistent with the purposes of IRC Section 4966. For example, if a donor recommends a distribution to a charity and the donor then arranges for the charity to make distributions to individuals recommended by the donor, the initial DAF distribution will be considered a taxable distribution from the sponsoring organization to individuals.

Key Observations

- *The concept of a "deemed distribution" broadens and increases uncertainty around when a distribution will be a taxable distribution. The anti-abuse rule further heightens this risk, since an otherwise permissible DAF distribution may be treated as taxable if the recipient acts as an intermediary and re-grants the funds as directed by the DAF donor (even if the sponsoring organization has no knowledge of such plan).*

- *The Proposed Regulations clarify/confirm that ED is an option.*

- *The change in ER requirements could have a significant impact on sponsoring organization reporting requirements for ER grantees and may limit their ability to make ER grants to foreign entities whose programs involve grants by such entities to individuals such as grantee-controlled scholarship programs, even if such programs would comply with the procedures required under IRC Section 4945.*

Who Is Subject to Excise Taxes for Taxable Distributions?

The IRC Section 4966 tax on taxable distributions is imposed on the sponsoring organization as well as on any "fund manager" who "agreed" to the making of the distribution, "knowing" that it is a taxable distribution.

The Proposed Regulations define a "fund manager" as (i) an officer, director, or trustee of the sponsoring organization or any person having similar authority or responsibility, or (ii) with respect to any act (or failure to act) that results in a taxable distribution, an employee who has final authority or responsibility (either individually or as a member of a collective body) for the act (or failure to act). Among others, a fund manager can include an investment manager if the sponsoring organization's governing body has delegated to them the final authority to make certain investment decisions.

A fund manager will be considered to "agree" to a distribution if they manifest approval, even if their decision is not the final or decisive act that leads to a taxable distribution. In addition, a fund manager will be considered to "know" that something is a taxable distribution if they are in fact aware that it is a taxable distribution or if they have knowledge of facts sufficient to determine that, based on those facts, the distribution would be a taxable distribution and they negligently fail to make reasonable attempts to ascertain whether the distribution is a taxable distribution.

Key Observations

- *The standards for fund manager liability are broad and extend beyond final decisional authority and actual knowledge to include approval of a distribution at any stage of consideration, as well as consideration of facts tending to show that a fund manager has reason to know that a distribution would constitute a taxable distribution.*

- *In addition to potential liability as a "donor-advisor" under IRC Sections 4958 or 4967, an investment manager of a DAF may also be considered a "fund manager" and face*

additional excise tax liability under IRC Section 4966 if they have been delegated investment authority and knowingly agree to make a taxable distribution.

What Funds are Excluded from DAF status?

The Proposed Regulations elaborate on and expand the statutory exceptions for funds that are excluded from DAF status:

Funds that make grants to a single identified organization: A fund that makes grants to a single identified organization that is a public charity described in IRC Section 509(a)(1), (2), or (3) (other than a disqualified supporting organization) or a governmental entity described in IRC Section 170(c)(1) for public purposes is generally not a DAF. Distributions from the fund must be used in the single identified organization's activities, rather than in administering DAFs or grant-making, and they must be made directly to the single identified organization and not to third parties on its behalf. In order to qualify for this exception, a donor, donor-advisor, or related person cannot have, or reasonably expect to have, the ability to advise regarding distributions from the single identified organization to other individuals or entities, and the distribution cannot provide, directly or indirectly, a more than incidental benefit to a donor, donor-advisor, or related party. The sponsoring organization may rely on a certification from the donor with respect to these last two requirements.

Scholarship funds: A fund in which a donor or donor-advisor advises as to which individuals will receive grants for study, travel, or other projects is not a DAF if it meets certain conditions. Among other requirements, the donor or donor-advisor may provide advice only in their capacity as a member of a selection committee that is appointed by the sponsoring organization and which they do not "control" along with related persons. The Proposed Regulations consider factors establishing direct control (e.g., 50% voting power or veto rights) as well as indirect control as determined by all facts and circumstances. The Proposed Regulations also add a related exception to DAF status for scholarship funds established by a broad-based membership IRC Section 501(c)(4) organization (like the Rotary Club), provided the fund serves a charitable class and other requirements are met.

Disaster relief funds: The Proposed Regulations exclude from the definition of a DAF a fund whose single identified charitable purpose is to provide relief from one or more "qualified disasters" within the meaning of IRC Sections 139(c)(1), (2) or (3). The Proposed Regulations broaden existing guidance available for employer-sponsored disaster relief funds (in Notice 2006-109) and include non-employment-based disaster relief funds. Similar requirements apply as in the scholarship fund context with some modifications, including that if the fund gives preference or priority to employees or their relatives, a majority of the selection committee cannot be in a position to exercise substantial influence over the affairs of the employer.

Key Observations

- *The Proposed Regulations add the provision that a donor, donor-advisor, or related person cannot have or reasonably expect to have the ability to advise on distributions from the single identified organization to other individuals or entities. According to the Preamble to the Proposed Regulations, if the donor is on the Board of Directors of that organization, that suggests that the donor has the ability to advise on some or all of the distributions from the public charity to other entities. While this is relevant for the narrow purpose of qualifying for the single identified organization exception to DAF status, it could have further-reaching consequences with respect to DAF grants recommended by donors to charities in which they are involved.*

Looking Ahead

The Proposed Regulations under IRC Section 4966 are just the first of several planned regulatory projects related to DAFs. The IRS has continued to list on its latest Priority Guidance Plan regulations under IRC Section 4967 regarding prohibited benefits and excise taxes on donors, donor advisors, related persons, and fund management, as well as regulations relating to the application of IRC Section 4958 to donor advised funds. In addition, there have been recent legislative efforts to

amend certain statutory DAF rules, particularly with respect to the relationship between DAFs, the public support test, and private foundations.

We will be keeping abreast of all of these developments and will share additional relevant information as it becomes available. Please contact us if you would like to discuss the potential impact of the Proposed Regulations on your funds or programs.

This alert is for general informational purposes only and should not be construed as specific legal advice. If you would like more information about this alert, please contact one of the following attorneys or call your regular Patterson contact.

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