ALERT

November 15, 2023

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New Proposed Donor-Advised Fund Regulations May Broaden DAF Treatment, Chill Donor Involvement, and Threaten Tax Deductions

On Tuesday, November 14, 2023, the Treasury Department issued new Proposed Regulations for donor-advised funds (DAFs) which will dramatically affect many charitable funds. In particular, these Proposed Regulations, if made final, will subject many funds that are not currently treated as DAFs to the restrictive DAF rules, will significantly curtail certain common DAF structures and strategies, and may threaten tax deductions for contributions to a broad array of charitable funds where donors may serve on committees or in other advisory roles.

The Pension Protection Act of 2006 imposed extra rules on DAFs that do not apply to non-DAF funds at public charities. Those rules include:

- ***Restrictions on distributions***: Section 4966 of the Code taxes DAF sponsoring organizations on distributions from DAFs to any organization other than certain public charities without satisfying the "expenditure responsibility" requirements, distributions to individuals, and distributions for non-charitable purposes.
- ***Restrictions on benefits to donors or advisors***: Section 4967 of the Code taxes donors, donor-advisors, and potentially fund managers whenever a donor or donor-advisor receives any more than incidental benefit as a result of a DAF distribution.
- ***Preclusion of grants, loans, compensation or similar payments to donors or donor-advisors***: Section 4958(c)(2) of the Code treats any grant, loan, compensation or similar payment to a donor or donor-advisor as a *per se* "excess benefit" transaction, subject to tax.
- ***Extra substantiation requirements***: Section 170(f)(18) provides that donors to DAFs will not receive any tax deduction if their acknowledgement letters do not (in addition to the requirements for standard acknowledgement letters) include an extra disclaimer that the DAF sponsor has exclusive legal control over donated assets.

These Proposed Regulations Address:

1. What constitutes a donor-advised fund ("DAF"),
2. Who is a "donor" or a "donor-advisor" subject to these rules,
3. Exceptions to DAF treatment (including certain scholarship funds and disaster relief funds), and
4. What constitutes an impermissible "taxable distribution" from a DAF.

Matters Not Addressed:

Other matters related to DAFs (including what constitutes an impermissible benefit under section 4967 of the Code, how DAFs and private foundations relate to one another, and whether DAF grants should be treated by recipients as "public support" for purposes of qualifying as a public charity) are not yet addressed, although existing guidance in IRS Notice 2017-73 continues to apply with respect to many of these questions.

Below are several highlights from the Proposed Regulations that might affect current DAF holders and structures:

Ability to Use Compensated Personal Investment Advisors for DAFs Effectively Precluded

While DAFs are like private foundations in certain respects, in a few areas the rules for DAFs are actually more strict than the comparable private foundation rules. One of those areas involves the ability of DAFs to pay compensation for services provided by certain disqualified persons. Private foundations are allowed to pay reasonable compensation for personal services to disqualified persons, but DAFs are not – under section 4958(c)(2) of the Code, any "grant, loan, compensation, or other similar payment" from a DAF to certain recipients is treated as a *per se* "excess benefit transaction" and subject to tax in its entirety, regardless of whether the payment was reasonable. Recipients subject to this tax include any DAF donor, any designated DAF advisor, and certain family members or related parties, where the donor (or advisor) has advisory privileges with respect to the distribution or investment of fund assets.

In the Proposed Regulations, the Treasury Department takes the position that an investment advisor that also manages the DAF donor's personal assets (defined in the Proposed Regulations as a "personal investment advisor") is subject to these rules, and that any payment by the DAF of compensation for investment advisory services provided by a personal investment advisor is an impermissible excess benefit transaction. DAF assets can be invested by an investment advisor who services the DAF sponsor as a whole, or by one who does not manage any personal assets of the DAF donor, but DAF assets cannot be used to compensate a DAF donor's personal investment advisor.

Many DAF sponsors (including both commercial DAF sponsors and community foundations) offer their DAF donors the ability to have their personal investment advisors participate in or manage DAF assets.

The Treasury Department explains, in its preamble to the Proposed Regulations, that in its view "the close relationship between a donor and his or her personal investment advisor" gives "the donor influence over investment decisions with respect to assets held in the DAF" to the extent that these investment advisors should be treated as subject to these restrictions. The Treasury Department further notes that allowing donors to designate their personal investment advisors to invest DAF assets may incentivize retaining assets in the DAF, rather than distributing them out to public charities.

Definitions of Donor-Advised Fund, Donor, and Donor-Advisor

Section 4966(d)(2) of the Code defines a donor-advised fund as a fund that is (1) separately identified by reference to contributions of a donor or donors, and (2) with respect to which a donor (or any person appointed or designated by the donor) has, or reasonably expects to have, by reason of the donor's status as a donor, advisory privileges with respect to the distribution or investment of amounts in the fund. It is important to look at every fund a charity has (not just ones that the charity labels as "donor-advised funds") to determine whether, under these rules, that fund will be treated as a DAF and subject to these restrictions. This is particularly important for funds that make grants to individuals, as DAF treatment will preclude that fund from making such grants.

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Is the fund "separately identified" by reference to a donor or donors? The Proposed Regulations take a very broad interpretation of when a fund is separately identified by reference to a donor's contributions. If a DAF sponsor tracks contributions of a particular donor with respect to any fund (including multi-donor funds), that fund will be treated as a DAF and subject to these rules. If instead the sponsoring charity does not track a particular donor's contributions, the IRS applies a "facts and circumstances" analysis to determine whether the fund is "separately identified" by reference to a donor or donors. These facts and circumstances include how fund account balance statements are arranged and presented; whether the fund is named after donors or related persons; whether the organization refers to the fund as a DAF; whether the sponsor has an understanding with donors regarding provision of advice; whether particular donors regularly receive fund statements; and whether the DAF sponsor in fact generally solicits advice from donors. With respect to multi-donor funds, the preamble to the Proposed Regulations states that "in most circumstances, a multiple-donor fund or account would be separately identified by reference to contributions of a specific donor or donors." This could include many field of interest funds or other charitable funds that donors and charities may not think of as DAFs subject to these rules, where (1) the charity tracks the contributions of individual donors with respect to the fund or reports on the fund to particular donors in the ways discussed above, and (2) one or more of the fund donors serve on committees or otherwise may have the ability to advise the charity regarding distributions or investment of funds.

Who is a "person appointed or designated by the donor"? Of course, when a donor designates someone (such as a family member) to have advisory privileges, that person is a "donor-advisor" subject to these rules. In addition, as discussed above, the Proposed Regulations would treat personal investment advisors of the donor as "donor-advisors" subject to these restrictions. In addition, the

Proposed Regulations provide that a person who establishes a fund and who has advisory privileges over the fund will be treated as a donor-advisor, even if the person is not a donor to the fund (on the theory that those contributing to the fund effectively designated this person as their donor-advisor) – this rule would apply, for example (as the preamble discusses) where someone establishes a memorial fund to honor someone who has died, collects donations from multiple sources, and has an ongoing role in advising regarding use of the funds (whether or not the founder of the fund has contributed to it). Such a fund, if treated as a DAF under these Proposed Regulations, will not be able to make grants to individuals or do anything else that a DAF cannot do.

Committee Service. Many funds have committees of individuals who play various advisory and other roles. Often, these committees consist of a combination of donors, donor-advisors, and community members. The Proposed Regulations generally would treat committee members as "donor-advisors" of a fund except in certain limited circumstances.

> Appointing a donor, donor-advisor or related person to any advisory committee of any fund may convert that fund into a DAF unless:
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> 1. the appointment is made based on objective criteria related to the appointee's expertise in the particular field of interest or purpose of the fund;
> 2. the committee consists of three or more individuals, not more than one-third of whom are related persons with respect to any of the others; and
> 3. the appointee is not a significant contributor to the fund (aggregated with related persons).

Even allowing a donor (or donor-advisor) to recommend someone to serve on an advisory committee can convert the fund into a DAF, unless the person recommended is an expert (appointed based on objective criteria) and is not related to the donor or any donor-advisor, and a majority of the committee is not recommended by the donor or donor-advisor. To avoid DAF treatment for funds (such as many field of interest funds) with committees, it is important either to confirm that the DAF sponsor does not "separately identify" any portion of the fund with respect to any donor, or else to minimize or eliminate the role of donors in serving on, or recommending who will serve on, fund committees involving distribution or investment of fund assets.

When does a donor (or advisor) have advisory privileges "by reason of the donor's status as a donor"? Where a donor has signed a DAF agreement granting advisory privileges, it is clear that those privileges are in place because of the donor's status as a donor. Where a donor is also serving as an officer, director, or employee of the DAF sponsor, and is giving advice solely in that fiduciary or employment capacity, the fund over which they are giving advice is not necessarily treated as a DAF, even if they contributed to it. However, where a DAF sponsor (such as a community foundation) appoints a director or officer, who is also a donor to a fund, to serve on a committee (or other group) that has influence over distributions or investments of the fund, the IRS will look at all the facts and circumstances to determine whether that donor was given that position of influence over the fund because of his status as a donor.

Where the donor is the sole person with those advisory privileges (whether or not serving in that role as a director, officer or employee), the donor will be deemed to have those privileges by reason of the donor's status as a donor.

***Exceptions to DAF Treatment*.** Certain funds are not treated as DAFs, regardless of whether they are "separately identified" with reference to one or more donors or whether donors or others have advisory privileges. These excluded funds include funds for the benefit of a single identified organization, certain scholarship funds, and certain disaster relief funds. The Proposed Regulations expand on the existing exceptions, and add a couple of new ones – in particular, (1) certain disaster relief funds (not just employer-sponsored disaster relief funds, which were previously excluded from DAF treatment under IRS Notice 2006-109) will now avoid DAF treatment; and (2) certain scholarship funds established by 501(c)(4) organizations (like the Rotary Club) that may not have qualified for the statutory exception of section 4966(d)(2)(B)(ii) of the Code will now avoid DAF treatment.

***Public Charity Funded DAFs*.** One welcome clarification is that 501(c)(3) public charities and governmental units are not considered "donors" for purposes of the DAF rules. That means that public charities and governmental units may establish DAF-like funds at community foundations and other DAF sponsors, and retain advisory privileges over those funds, without necessarily subjecting the funds to the restrictive DAF rules, if certain requirements are met. Notably, however, private foundations do not qualify for this exception – rather, if a private foundation makes a grant to a DAF, the private foundation (and anyone the foundation designates to have advisory privileges) and the fund established by it will be subject to the DAF rules.

Taxable Distribution Rules

***Anti-Abuse Rule*.** While DAFs cannot make grants to individuals, or to organizations other than public charities (without exercising expenditure responsibility or, for certain foreign charities, procuring an "equivalency determination"), DAFs have always been allowed to make grants to public charities, or to field of interest funds managed by the DAF sponsor or elsewhere, which may then do at least some of these things that the DAF couldn't do directly. The Proposed Regulations include an "anti-abuse" rule under which a grant from a DAF to a public charity or a charitable fund that is then used in a way that the DAF couldn't have done directly may be collapsed and treated as a direct grant or use by the DAF of those funds. This could result in imposition of a tax on the DAF sponsor based on use of funds outside of the DAF sponsor's knowledge or control (for example, if a donor has a private arrangement with a recipient public charity as to how the funds will be used, of which the DAF sponsor is unaware).

Accordingly, if these Proposed Regulations are finalized in this form, DAF sponsors will need to consider, when making any grant, whether a donor or donor-advisor is advising the grant recipient as to what to do with the DAF distribution. In addition, when using DAF funds to contribute to a field of interest or other fund (such as a disaster relief fund) held by the DAF sponsor, it is important that the DAF donor or donor-advisor not play any role (including as a committee member) with respect to distributions from that recipient fund, as they relate to the distribution from that donor's DAF, and that the DAF sponsor can otherwise demonstrate that the use of the distributed DAF funds by the field of interest or other non-DAF fund was not connected with the original DAF grant.

Program-Related and Mission-Related Investments. Distributions to organizations that are not public charities are generally treated as "taxable distributions" under section 4966 of the Code. The Proposed Regulations construe the term "distribution" broadly, including for purposes of analyzing whether a particular transaction is a grant or an investment. As the preamble notes, a zero-interest loan is generally treated as a distribution, whether or not that loan would qualify as a "program-related investment" if made from a private foundation, or is otherwise mission-related. Any investment that appears to have some donative element to it (including many below-market mission-related or program-related loans or investments) should be analyzed as grants and made in a way so as to comply with the expenditure responsibility rules or otherwise avoid treatment as a "taxable distribution."

DAF Grants to Foreign and Non-Charitable Organizations. The Proposed Regulations confirm that DAFs may make grants to foreign charities or to non-charities (such as 501(c)(4) social welfare organizations and for-profit organizations) so long as the DAF sponsor procures an equivalency determination (for grants to foreign charities) or complies with the expenditure responsibility requirements. The Proposed Regulations further address how to translate the private foundation expenditure responsibility rules into the DAF context, including requiring recipients to confirm that they will not do anything with the DAF funds that the DAF could not do (such as making grants to individuals). In addition, the Proposed Regulations add the requirement (currently a requirement for grants by private foundations to non-charities) that funds granted under expenditure responsibility must be separately accounted for by the recipient, in either a separate bookkeeping account or a separate physical account devoted exclusively to charitable purposes.

Potential Threat to Income Tax Deductions

As noted above, these Proposed Regulations could convert many charitable funds (including field of interest funds) where donors serve on committees or in other advisory roles unexpectedly into DAFs in the eyes of the IRS. In addition to resulting in potential taxes on DAF sponsors for impermissible distributions, or taxes on DAF donors or advisors on benefits received by them, this unexpected DAF treatment could also threaten the income tax deductions for donors to these funds. This is because of the substantiation rules of section 170(f)(18) of the Code, which provide that acknowledgement letters for gifts to DAFs must specify that the sponsoring charity has exclusive legal control over donated funds. The courts have interpreted this requirement strictly, as demonstrated in the recent (2022) case of *Keefer v. U.S.*, in which a federal district court in Texas denied an income tax charitable deduction of more than $1.25 million in part because the acknowledgement letter did not include this language.

Acknowledgement Letters:

- **Acknowledgement letters for gifts to DAFs** must specify that the sponsoring charity has exclusive legal control over donated funds.
- **Acknowledgement letters for gifts to non-DAF funds** generally do not include this language.

Charities may wish to start including this language in all acknowledgement letters where there is any risk that recipient funds might be treated as DAFs.

Applicability

The Treasury Department requests comments on the Proposed Regulations, which are due by January 16, 2024. Although these Proposed Regulations are not yet final, the preamble proposes that the regulations would become applicable "to taxable years **ending after** the date of publication" of final regulations (emphasis added). If this applicability date is adopted, that means that any final regulations could be applied retroactively to the beginning of the tax year during which the final regulations are issued. Accordingly, all donors and DAF sponsors should review their DAF structures now to determine the extent to which they comply with these Proposed Regulations, and should submit comments before January 16, 2024 to the extent they want to influence the form of the final regulations.

Contact Us

We will continue to keep you updated on these proposed regulations. Please contact the author of this alert or a member of our Nonprofit Group if you have questions.

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