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5 Things Advisors Need to Know About the Proposed DAF Regulations

POTENTIAL IMPLICATIONS FOR DONORS AND THEIR ADVISORS

What are the recently proposed donor-advised fund (DAF) regulations issued by the U.S. Department of Treasury and the IRS? How will they affect your decision to recommend the right charitable vehicle for your clients? What's the difference between a DAF and a private foundation? We asked two leaders in the tax-exempt space to give us a brief update on the proposed regulations, their potential to restrict common DAF structures and their impact on how advisors may be compensated (among other changes). Here is a summary of the discussion from our webinar with **Foundation Source's Chief Legal Officer, Jeffrey Haskell, and Brad Bedingfield, partner and chair of The Nonprofit Group at Hemenway & Barnes.**

#1 Differences Between a DAF and Private Foundation

A DAF is a fund inside a public charity, a "sponsoring organization," while a private foundation is its own separate legal entity with separate control structures and separate rules. There are some tax, governance and compliance differences between the two and, as a result, some favor DAFs while others favor private foundations. For example, donors to DAFs often get a better tax deduction, depending on the donor's tax situation, while private foundations can do certain things that DAFs can't, such as make grants to individuals and pay reasonable and necessary compensation to related parties for legal, investment and other professional services.

#2 Proposed Regulations and Definition Changes

- In 2006, the Pension Protection Act created a statutory framework for DAFs, including a definition for a DAF and special rules applicable to them. But we've been without regulations to interpret those statutory provisions for quite some time now. It's expected that final regulations are going to be fast-tracked and may be issued this year.
- The final regulations are expected to be effective, at least per the proposed regulations, in the same tax year in which they're issued instead of in the following tax year. For example, if you have a calendar year sponsoring organization—the public charity that's hosting the DAF—the final regulations will be in effect as of January 1, 2024, if they're adopted during 2024.
- Because the risk remains that the final regulations might be applied retroactively, charities that sponsor DAFs are making changes now in anticipation of some of the things that are signaled in the proposed regulations.
- The definition of a DAF in the proposed regulations is much broader than the statutory definition. The statutory definition of a DAF is a fund at a public charity that satisfies two prongs: first, that the fund is separately identified by reference to contributions of a donor(s), and second, with respect to that fund, the donor (or somebody the donor appoints or designates) has or reasonably expects to have advisory privileges with respect to distributions or investments. If the fund fails either of these prongs, it's not a DAF.
- The proposed regulations take an extremely broad view with respect to the first requirement—that the fund be "separately identified." In fact, the newly proposed definition is so broad that it effectively makes every fund at every charity separately identified.
- Therefore, the focus for charities has been whether their funds will be considered DAFs due to satisfaction of the second prong—the requirement that a donor (or someone they appoint) has, or reasonably expects to have, advisory privileges with respect to distributions or investments. However, this is quite broad as well and, as a result, vastly more funds that weren't previously considered DAFs—and that people don't typically think of as DAFs, such as field-of-interest funds and memorial funds may be treated as DAFs and subject to the special DAF restrictions.

#3 The Practical Consequences of the Proposed Regulations

- Sponsoring organizations may host a range of funds, some of which may not have been established as DAFs. For instance, a sponsoring organization may have field-of-interest funds and memorial funds, both of which can do things that DAFs are not allowed to do.
- If these funds are considered DAFs under the regulations and they make grants to organizations that aren't classified as public charities, the sponsoring organization would need to exercise special oversight procedures known, collectively, as expenditure responsibility. However, many sponsoring organizations aren't currently equipped to do.
- Additionally, DAFs can never make grants to individuals. This is one of the big differentiators between DAFs and private foundations, which are allowed to do so under certain circumstances.
- If a field-of-interest fund or memorial fund is treated as a DAF because of these broad interpretations, then it may no longer be able to engage in the kind of charitable work that it's been conducting for many years.
- Lastly, although contributions to DAFs are tax-deductible, donors need an acknowledgement letter from the sponsoring organization that contains DAF-specific language for the letter to be valid. This expanded definition of a DAF could result in the omission of such language from donor acknowledgment letters issued for donations to funds that the sponsoring organizations didn't consider to have been DAFs.

#4 The Impacts on Advisors

- The proposed regulations likewise impact a DAF donor's professional investment advisor who provides advisory services to, and is paid by, the donor's DAF. From the IRS' perspective, this is seen as potentially abusive, on the theory that the personal investment advisor may not want assets going out from under their purview and, therefore, may steer the fund away from making distributions.
- Under the newly proposed regulations, a DAF donor's personal investment advisor generally can't be compensated out of DAF funds for advising on the DAF. However, with a 17-year gap between the enactment of the statutes and the proposed regulations, this has become very common.
- Therefore, if these rules are applied retroactively, some investment advisors may be personally subject to tax penalties for such arrangements that are currently in place.
- There are a number of rules around prohibited benefits from donor-advised funds. Under the excess benefit rules of Section 4958 of the Internal Revenue Code, a DAF is not permitted to pay any level of compensation to a donor or a donor advisor. If it does, that is a per se excess benefit transaction and is subject to a penalty payable by the investment advisor. Further, the payment of this compensation will likely be treated as an impermissible taxable distribution as well under IRC Section 4966, with a penalty payable by the sponsoring organization.

#5 The "Anti-Abuse" Rule

- The "Anti-Abuse Rule" in the proposed regulations would fall under the taxable distribution rules of IRC Section 4966. Under this rule, whenever the donor or the DAF sponsor arranges for a subsequent use of grant funds in a way that the DAF could not engage in directly, then the two transactions will be collapsed and treated as if the DAF had engaged in the impermissible use of the funds directly, subjecting the sponsoring organization to a penalty.
- Under the proposed regulations, a sponsoring organization can be penalized due to an arrangement made solely by the donor without any involvement—or even knowledge—of the sponsoring organization. For instance, a DAF sponsor could comply with a donor's request to make an unrestricted grant to a public charity, but the donor—unbeknownst to the sponsoring organization—could ask the charity to distribute the grant funds to individuals. Under the Anti-Abuse Rule, the IRS could collapse the two transactions, imposing a penalty on the sponsoring organization rather than on the donor who made the arrangement without the sponsoring organization's knowledge.
- To navigate compliance with this rule and possibly reduce risk with respect to these grants, the sponsoring organization could require each grantee to agree in writing, at the time of the grant, that it will not consult with any donor, donor advisor or related party with respect to the grant. Doing so should support the position that prohibited arrangements for subsequent use of grant funds have been ruled out. While this wouldn't necessarily prevent the IRS from collapsing the transactions if it were to happen, it may give the sponsoring organization a "reasonable cause" argument for avoiding the penalty.

A number of industry and professional organizations have submitted comments to Treasury on the above concerns with the hope that this will have some effect on the final regulations. A public hearing is scheduled for May 6, 2024. Check the irs.gov website for more information.

Want to learn more? Check out the webinar here.

HAVE A QUESTION?

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