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Making Sense of the Donor Advised Fund Regulatory Landscape

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Donor-advised funds ("DAFs") have existed in some form for many years but were only codified along with some related excise taxes in the Pension Protection Act of 2006 (the "PPA"). The PPA clarified that organizations that sponsor DAFs are classified as public charities under the Internal Revenue Code of 1986, as amended (the "Code"), but are subject to some of the private foundation excise taxes (such as excess business holdings under Section 4943 and the expenditure responsibility requirements under Section 4945) as well as excise taxes that apply specifically to sponsoring organizations (including Section 4966 taxes on taxable distribution and Section 4967 taxes on prohibited benefits). Since the PPA, there has been relatively little guidance regarding the rules applicable to DAFs, though there has been significant criticism of DAFs from both the public and legislators.

In November of last year, however, the Internal Revenue Service (the "IRS") and the U.S. Department of the Treasury issued proposed regulations (REG-142338-07) under Section 4966 (the "Proposed Regulations") that provide important clarifications and address a number of open issues related to the operation and administration of DAFs. The Proposed Regulations were issued under Code Section 4966 and relate to taxes on taxable distributions by DAFs. The Proposed Regulations principally provide more detailed definitions of key terms that were codified in Section 4966. In particular, the Proposed Regulations answer some important questions and provide more clarity about what types of funds are considered DAFs, who will be considered a donor or donor-advisor to a DAF, what is considered a distribution from a DAF, and who is an appropriate recipient of a distribution from a DAF.

While these long-awaited Proposed Regulations provide more detailed definitions of key terms that were codified in Section 4966, answer some important questions related to the operation and administration of DAFs, and provide more clarity around some issues, they have also raised numerous questions and criticisms.

Following the issuance of the Proposed Regulations, more than 150 organizations or individuals provided comments on the Proposed Regulations. On May 6th and 7th, 2024, following the comment period, the IRS held a two-day public hearing during which 34 individuals provided public comments on the Proposed Regulations. Many commenters expressed the view that the proposed regulations, if adopted as final, would have a chilling effect, not only on the use of traditional DAFs but also on the use of many kinds of funds that would likely be treated as DAFs under the regulations.

Since the Proposed Regulations were issued and these public hearings were held, the IRS has neither finalized nor issued any other guidance or updates related to the Proposed Regulations. The sector, however, has tended to focus in on a few main issues, all of which were heavily discussed in both the written comments submitted to the IRS and the comments made during the public hearings. This outline will provide an overview of those areas of the Proposed Regulations that have received the most attention, including an overview of the guidance included in the Proposed Regulations with respect to each issue.

As discussed above, comments from the public on the Proposed Regulations predominantly focused on four key issues:

1. **The broad definition of DAF:**

The Proposed Regulations adopt a broad definition of the term DAF, restating the broad statutory definition and providing for only limited exceptions. Sponsoring organizations will need to assess whether funds that they have historically excluded as DAFs will be required to be treated and reported as DAFs going forward.

The Proposed Regulations adopt the Section 4966(d)(2)(A) definition of DAF and provide additional guidance regarding whether a fund or account is "separately identified by reference to contributions of a donor or donors" and whether there is at least one donor-advisor with "advisory privileges." Under the Proposed Regulations, a fund is separately identified if the sponsoring organization maintains a formal record of contributions to the fund or account relating to a donor or donors (presumably this amounts to something more than the records that would be required to demonstrate public support or provide substantiation of contributions). If these records are not present, a facts and circumstances test applies, and the Proposed Regulations list a number of facts that tend to show that a fund is separately identified, including whether the fund balance reflects items such as contributions, dividends, interest, distributions, administrative expenses, and gains and losses; the fund is named after one or more donors, donor-advisors, or related persons; the sponsoring organization refers to the fund as a donor-advised fund or has an agreement with donors or donor-advisors that it is a donor advised fund; one or more donors or donor-advisors regularly receive a fund statement from the sponsoring organization; or the sponsoring organization generally solicits advice from the donor or donor-advisors.

The Proposed Regulations also establish a facts and circumstances test to determine the existence of advisory privileges, and clarify that, with certain limited exceptions, advisory privileges are generally deemed to exist by reason of a donor's status as a donor. Advisory privileges also exist if any of the following are true, regardless of whether a 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 they have advisory privileges, iii) documents or marketing materials indicate a donor or donor-advisor may provide advice, or iv) the sponsoring organization generally solicits advise from a donor or donor-advisor. The Proposed Regulations include specific rules for determining whether individuals appointed by the donor to an advisory committee have advisory privileges.

DAF Exceptions

While DAFs are broadly defined under the Proposed Regulations, there are some limited exceptions to the definition of a DAF:

- *Funds making distributions only to a single identified organization* – funds that make distributions only to a single identified organization described in Section 170(c)(2) or

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