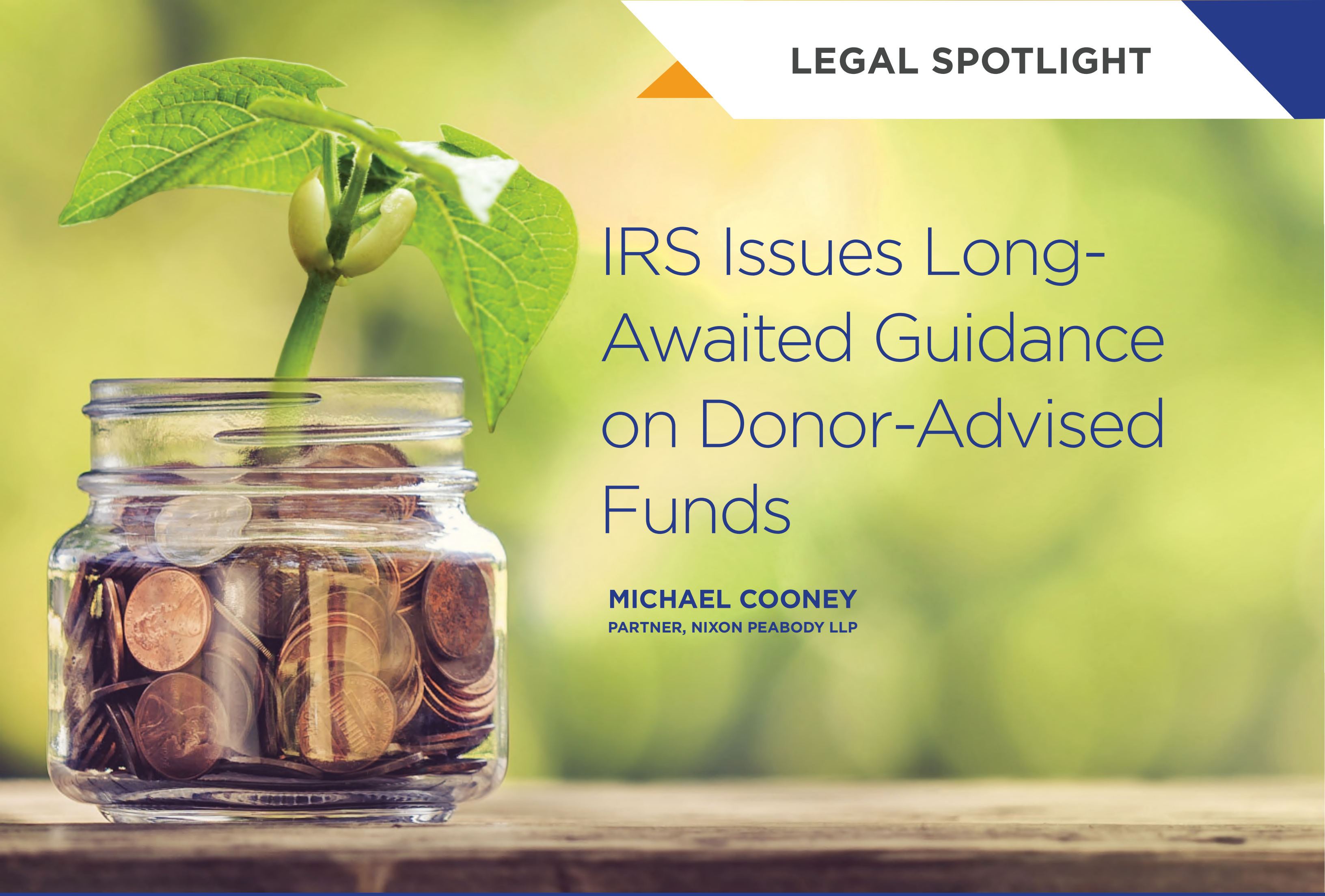

IRS Issues Long-Awaited Guidance on Donor-Advised Funds

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GUEST PERSPECTIVE

Donor-advised funds (DAFs) have experienced rapid growth in recent years, and many experts expect them to become even more popular as a result of the new tax bill's increased standard deduction. Donors who are no longer itemizing their charitable deductions may opt for the immediate tax benefits of a DAF instead.

Despite their popularity and wide-spread positive impact on the nonprofit industry, DAFs have been subject to inconsistent regulation and infrequent guidance from the IRS over the years – but that may be about to change now that new interim guidance and proposed regulations have been released.

WHAT IS A DONOR-ADVISED FUND?

A DAF functions similarly to a charitable trust, but without all the paperwork of a trust. Donors can make irrevocable gifts to DAFs which entitle them to immediate charitable contribution deductions.

The public charity sponsor of the DAF has the authority to hold and invest the corpus of the gift and distribute it to a public charity donee either immediately, or within a stated number of years – typically five years. Although the DAF sponsor may donate any amount to any qualified charitable donee, it typically follows the advice of the original donor or her designee.

Thus, the donor (or designee) may offer nonbinding recommendations to the public charity sponsoring the DAF. In order to assure a completed gift for deduction purposes, the advisory privilege cannot rise to the level of a material restriction or condition, a concept born out of the regulations under Section 507 of the Internal Revenue Code of 1986, as amended (the “Code”).

LONG HISTORY OF INCONSISTENT REGULATION

While the concept of the DAF has been around for decades, Congress only saw fit to recognize and regulate them in the Pension Protection Act of 2006, imposing many (but not all) of the requirements applicable to private foundations, while creating some special obligations under Code Sections 4958, 4966, and 4967. Attempts to further regulate DAFs in the recent Tax Cuts and Jobs Act failed, but will likely be revisited.

The promotion of DAFs has had a strong positive effect on charitable giving. The National Philanthropic Trust’s “Donor Advised Fund Report 2017” states that annual contributions into DAFs were $23.27 billion in 2016, with DAF distributions to charities totaling $15.75 billion. Yet Congress’ approach to charities regulation has resulted in a number of structural inconsistencies, rendering the DAF a bit of a platypus – neither wholly public charity nor private foundation.

NEW IRS GUIDANCE ISSUED

These inconsistencies are the basis for recent IRS Notice 2017-73, providing both interim guidance and proposed regulations.

The first of these is the going “Dutch” rule, set out in Private Letter Ruling 9021066 for private foundations, and generally followed for DAFs. Assume some charitable event (a dinner perhaps) or membership qualification which affords the donor certain benefits. The exchange portion of the payment (or quid pro quo) is not deductible, and the gift substantiation from the charity must state as much. But what if a donor uses his private foundation to pay the charitable (deductible) portion of the required payment, and the donor personally pays the rest?

The Service reasoned 27 years ago that, as the disqualified person would not be eligible for the benefits received based solely on his payment, the use of private foundation resources was self-dealing. The new Notice makes it clear that the same concept applies to *quid pro quo* payments from DAFs.

The satisfaction of a legally enforceable charitable pledge by a private foundation on behalf of a "disqualified person" is an act of self-dealing under Treas. Reg. § 53.4941(d)-2(f)(1). Similarly, a DAF may not, directly or indirectly, make a distribution which conveys more than an incidental benefit on the donor, DAF advisors, or certain related persons, according to Code Section 4967(a)(1).

"DON'T ASK, DON'T TELL" REGIME

Identifying DAF distributions which constituted legally enforceable pledge payments has become so burdensome, however, that the IRS has fashioned a "don't ask, don't tell" regime to protect sponsoring public charities.

That approach is now permissible, at least until modified by regulation, as long as the following requirements are satisfied:

- DAF sponsor cannot make any reference to the existence of a charitable pledge when making the DAF distribution.
- The DAF donor/advisor cannot receive, directly or indirectly, any other benefit that is more than incidental on account of the DAF distribution.
- The DAF donor/advisor cannot not attempt to claim an income tax charitable contribution deduction with respect to the DAF distribution, since she already deducted the full amount of her gift when originally made to the DAF.

IMPLICATIONS FOR PRIVATE FOUNDATIONS

DAFs are also a handy device for private foundations faced with an unsatisfied required distribution at year-end. Instead of needing to hurriedly distribute out grants, the private foundation can distribute to a DAF for subsequent disbursement. The Service is concerned about private foundations subverting the annual distribution requirement of Code Section 4942 in this way. Whether private foundations would have the continued benefit of this safety valve is unclear. The conduit foundation rules of Code Section 170(b)(1)(F)(ii) might provide a useful alternative.

Finally, the Service is concerned about private foundations flushing grants through DAFs in order to secure status as public support, based upon the public charity status of the sponsoring organization (such as a community foundation under Code Section 170(b)(1)(A)(vi)). Consider two scenarios. In the first, a donor makes a direct contribution to a charity. In determining its public charity status, the entity can only count two percent of support from the donor and all related persons. If the only support to the charity was from this one donor, the charity will probably fail the public charity test and be classified as a private foundation.

On the other hand, if that same donor makes a contribution to a DAF and then advises that the full amount be transferred to the eventual recipient, then the payment has the patina of the public charity sponsor of the DAF, unburdened by the two percent limitation. The circumstances need not be this dramatic; any payment which otherwise would "tip" a charity into private foundation status could come from a DAF.

DAFs are a popular tool for charitable giving, but raise many potential concerns which seem likely to be addressed in the coming months.

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