Craig Wruck - Fri, 1/12/2024 - 16:52

Just before the holiday season began in the fall of 2023, the Treasury Department published and sought comments on proposed regulations governing donor advised funds (DAFs). Although long anticipated, the proposed regulations caught many of us off guard. Was this the opening salvo, a continuing assault on DAFs, or the final barrage? Is there more here than meets the eye or less? And what's coming next? Before we dig into the proposed regulations and what they might mean for the future, let's review some history.

Our Story So Far…

The concept of a family foundation has been around for as long as wealthy individuals have been generous. For most of that time the terms "family foundation" and "private foundation" were synonymous, and neither one was defined in Federal law. In response to growing concerns that foundations had become a haven for tax cheaters, the Tax Act of 1969 codified private foundations and provided stringent rules governing them. Among the rules is a standing assumption that all 501(c)(3) tax exempt entities are subject to the private foundation rules unless the organization can prove it is a public charity.

There are many advantages to being a public charity instead of a private foundation, including the ability to maintain donor anonymity and the avoidance of minimum distribution requirements, excise taxes, and strict self-dealing rules, which apply to private foundations. In addition, the annual deduction limit for contributions to a public charity is double that for a private foundation (60% versus 30%).

A wide range of entities, including churches, educational institutions, and research organizations, are recognized as public charities by virtue of their charitable missions. Others must prove they are a public charity each year by meeting the "public support test," which requires that the organization receive at least one-third of its revenue in charitable contributions each year from public sources: individual/corporate donors, other charities, and government funding.

During the late 1800s and early 1900s, as wealth passed from one generation to the next, banks and trust companies found themselves responsible for the remnants of family foundations and saddled with the responsibility to ensure those funds were used for charitable purposes. In 1914 the first community foundation, The Cleveland Foundation, was formed by banks and trust companies as a vehicle to distribute charitable assets.

With the imposition of the public support test in 1969, community foundations were challenged to pivot and raise a significant portion of their annual revenue in new contributions each year or face the prospect of becoming a private foundation. The donor advised fund was an innovation to address the public support test by encouraging donors to make large contributions to the community foundation (a public charity), which are eventually distributed to other public charities. Donor advised funds were the exclusive province of traditional community foundations until 1991 when Fidelity created its Fidelity Charitable Gift Fund.

Donor advised funds have grown in popularity in part because they offer donors the advantages of a public charity contribution while functioning much like a private foundation. The National Philanthropic Trust estimates that there are two million donor advised funds that hold more than $225 billion in assets, receive more than $85 billion in new contributions each year, and distribute $50 billion annually. By comparison, IRS data indicate there are fewer than 80,000 private foundations, but they hold nearly one trillion dollars in assets and receive more than $80 billion in contributions and expend $100 billion for charitable purposes each year.

For decades, donor advised funds existed in legal limbo. As funds of a public charity (the community foundation), they have operated under a web of legal concepts and regulations governing community trusts and nonprofit fund accounting. Finally, the Pension Protection Act of 2006 provided legislative direction and then, 17 years later in the fall of 2023, these proposed regulations were issued.

Proposed Regulations

For the most part, the proposed regulations are focused on providing definitions, clarifying the roles and responsibilities of the parties, and clarifying the distinction between donor advised funds and private foundations. The regulatory approach, the big stick if you will, is to define certain donor advised fund distributions as taxable and apply an excise tax on them.

There is little surprising in the proposed definitions of “donor advised fund,” “donor,” “donor advisor,” or “advisory privileges.” In general, the proposed regulations merely formalize what has been common practice. In response to perceived and actual abuses from those with influence over donor advised funds, the proposed regulations explicitly call out an enhanced definition of “disqualified person.” (including the donor, advisor, or related parties). The proposed rules underscore that transactions with a disqualified person are excess benefit transactions potentially triggering a steep excise tax.

The concept of “disqualified persons” lurks in many corners of the tax code. They’ve long been a part of the private foundation rules limiting transactions by those closely related to the private foundation. The enhanced focus on disqualified persons and excess benefit transactions for donor advised funds may be intended to rein in some of the assumed advantages of a donor advised fund and could serve to level the playing field for private foundations.

The proposed regulations bring a significant change to the relationship between a donor advised fund and its investment managers, especially if there is a relationship between the donor or advisor and the investment manager. These provisions may be the crux of the proposed regulations: concerns about arrangements that allow the donor’s investment advisor to continue to be compensated even after the gift is made. This is not surprising in the context of the contention, popular among critics of donor advised funds, that donor advised funds have been abused by the wealthy as a way to secure a charitable deduction while warehousing money rather than making it immediately available for charitable purposes.

The proposed definition of “distribution” is simultaneously very broad and pointed. Any distribution or expenditure of any kind would be a distribution subject to the new regulations. If a distribution provides benefit to a donor, advisor, or anyone related to a donor or advisor, that distribution could be a “taxable distribution” subject to a 5% excise tax. Ordinary, necessary expenses of operating the donor advised fund are not considered taxable distributions. This includes reasonable expenses for investment management services but with this significant exception: if the donor or donor advisor has a relationship with the investment manager, then the costs of investment management could be a taxable distribution.

What Comes Next?

The deadline for comments has passed, although some have suggested an extension. Treasury will review the comments it received and could then issue further proposed regulations for additional comment or simply publish the final regulations. Given how long these proposed regulations have been in progress, it seems reasonable to expect the final regulations will be issued soon, but this is speculation.

In the meantime, can a donor rely on the proposed regulations? The answer is complicated and, of course, donors should consult their own advisors. As a general matter, taxpayers may not rely on proposed regulations for planning purposes, except if there are no applicable regulations already in place. In this case, some portions of the proposed regulations are entirely new and therefore fit this exception, but other parts do not.

Are the proposed regulations the end or is there more to come? What comes next is anyone's guess. Given the extraordinarily long gestation period for these proposed regulations, it might seem reasonable to predict this is it for a while.

On the other hand, recall the Accelerating Charitable Efforts Act (the "ACE Act") that was introduced by Senators King (I-ME) and Grassley (R-IA) in the previous Congress? The ACE Act would have made positively draconian changes to donor advised funds by drawing a sharp distinction between "qualified" and "nonqualified" donor advised funds (see our previous commentary). Although the ACE Act died in committee and has not been introduced in the current Congress, the text could be easily resurrected if Congress determines the proposed regulations do not go far enough.

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