The IRS provides guidance related to certain distributions from donor advised funds

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In Notice 2017–73, the IRS describes approaches that it and the Department of the Treasury are considering to address in future proposed regulations related to certain issues regarding donor advised funds (DAFs) of sponsoring organizations.

Proposed regulations are forthcoming

Long anticipated, the Treasury Department and the IRS are finally considering developing proposed regulations under section 4967 of the Internal Revenue Code that would, if finalized, provide that:

1. Certain distributions from a DAF that pay for the purchase of tickets that enable a donor, donor advisor, or related person under section 4958(f)(7), to attend or participate in a charity-sponsor event does result in a more than incidental benefit to such person under section 4967; and
2. Certain distributions from a DAF that the distributee charity treats as fulfilling a pledge made by a donor, donor advisor or related person, does not result in a more than incidental benefit under section 4967 if certain requirements are met.

In addition, in another long anticipated move, the Treasury Department and the IRS are considering developing proposed regulations that would change the public support computation for organizations described in sections 170(b)(1)(A)(vi) and 509(a)(1) and in section 509(a)(2) to prevent the use of DAFs to circumvent the excise tax rules applicable to private foundations under Chapter 42 of the Internal Revenue Code.

**Description of the issues**

Section 4966(d)(2) defines a DAF as a fund or account owned and controlled by a sponsoring organization, which is separately identified by reference to contributions of a donor or donors, and with respect to which the donor, or any person appointed or designated by such donor (donor advisor), has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the funds.

Any fund or account which makes distributions only to a single identified organization or governmental entity, or certain committee–advised funds that make grants to individuals for travel, study or other similar purposes is an exception from the definition of DAF.

Section 4966(d)(1) defines a sponsoring organization as an organization that:

1. Is described in section 170(c) (other than a governmental unit described in section 170(c)(1), and without regard to the requirement under section 170(c)(2)(A) that the organization be organized in the United States);
2. Is not a private foundation (as defined in section 509(a)); and
3. Maintains one or more DAFs.

Organizations described in section 170(c) set forth in requirement (1) above, include:

- A corporation, trust, or community chest, fund, or foundation—organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; no part of the net earnings of which inures to the benefit of any private shareholder or individual; and which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.
- A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—and no part of the net earnings of which inures to the benefit of any private shareholder or individual.
- A domestic fraternal society, order or association, operating under the lodge system, but only if contributions or gifts are to be used exclusively for religious, charitable, scientific, literary or educational purposes, or for the prevention of cruelty to children or animals.
- A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

Under section 170(f)(18), a deduction otherwise allowable under section 170(a) for a contribution to a DAF is allowed only if:

(A) The sponsoring organization is described in section 170(c)(2) and is not a type III supporting organization, as defined in section 4943(f)(5)(A) (other than a functionally integrated type III supporting organization as defined in section 4943(f)(5)(B)); and
(B) The taxpayer obtains a contemporaneous written acknowledgment from the sponsoring organization of the DAF that the sponsoring organization has exclusive legal control over the assets contributed.

Therefore, a sponsoring organization of a DAF may be a corporation, trust or community chest, fund, or foundation—created or organized in the United States or in any possession thereof, or under the law of the United States, any state, the District of Columbia, or any possession of the United States; organized and operated exclusively for religious, charitable, scientific, literary or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals; no part of the net earnings of which inures to the benefit of any private shareholder or individual; and which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

In addition, the sponsoring organization may not be a type III supporting organization which is not functionally integrated with its public charity supported organization. A functionally integrated supporting organization for this purpose is one that operates activities which are related to performing the functions of or carrying out the purposes of the supported public charity.

Section 4966 imposes an excise tax on each taxable distribution from a DAF. This excise tax is paid by the sponsoring organization. A separate excise tax, paid by fund managers, is imposed on the agreement of any fund manager to the making of a distribution, knowing that it is a taxable distribution. In general, a taxable distribution is any distribution from a DAF to any natural person, or to any other person if (i) the distribution is for any purpose not specified in section 170(c)(2)(B), or (ii) the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h).

A taxable distribution does not include a distribution from a DAF to:

1. Any organization described in section 170(b)(1)(A) (other than a disqualified supporting organization as defined in section 4966(d)(4));
2. The sponsoring organization of such DAF; or
3. Any other DAF.

Section 4967 imposes an excise tax on the advice that a person described in section 4967(d) provides regarding a distribution from a DAF that results in such person or any other person described in section 4967(d) receiving, directly or indirectly, a more than incidental benefit. Section 4967(d) refers to section 4958(f)(7), which describes a donor, donor advisor, a family member of a donor or donor advisor, or a 35-percent controlled entity of such persons as defined in section 4958(f)(3) (with the modifications described in section 4958(f)(7)(C)). This excise tax is paid by any person who advises the sponsoring organization as to the distribution or who receives the prohibited benefit. A separate excise tax, paid by fund managers, is imposed on the agreement of any fund manager of the sponsoring organization to the making of the distribution, knowing that it would confer a prohibited benefit. Section 4967(b) provides that, with respect to any distribution, no tax shall be imposed under section 4967 if a tax has been imposed under section 4958.

Section 4958 imposes an excise tax on any excess benefit transaction. Section 4958(c)(1) defines an excess benefit transaction generally as any transaction in which an economic benefit is provided by an applicable tax-exempt organization (including a section 501(c)(3) sponsoring organization of a DAF) directly or indirectly to or for the use of a disqualified person (including in the case of any transaction that involves a DAF a donor, donor advisor or a person related to a donor or donor advisor, as described in section 4958(f)(1)) if the value of the economic benefit provided exceeds the value of the consideration received. In general, the term excess benefit refers to the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

Section 4958(c)(2) provides that, in the case of any DAF, an excess benefit transaction also includes any grant, loan, compensation or other similar payment from the DAF to a donor, donor advisor or related person. For purposes of this special rule for DAFs, the excess benefit includes the full amount
of the grant, loan, compensation or other similar payment. This excise tax under section 4958 is paid by the disqualified person with respect to the transaction. A separate excise tax, paid by organization managers, is imposed on the participation of any organization manager in the transaction, knowing that it is an excess benefit transaction, unless such participation is not willful and is due to reasonable cause.

Notice 2006–109, 2006–2 C.B. 1121, provided interim guidance on several DAF issues, including criteria for determining whether a supporting organization is a disqualified supporting organization, exclusion of certain employer-sponsored disaster relief funds from the definition of DAF, and transitional rules for educational grants. The notice also requested comments regarding suggestions for future guidance on DAFs.


In response to the two notices mentioned above, the Treasury Department and the IRS received a number of comments requesting guidance on various DAF issues. Several commenters indicated that guidance would be particularly helpful regarding whether section 4967 prohibits a donor, donor advisor or person related to a donor or donor advisor of a DAF from advising a DAF distribution to pay the cost of any such person’s attendance or participation in a charity-sponsored event or to fulfill the person’s charitable pledge. The commenters noted that some DAF sponsoring organizations prohibit such DAF distributions, but others do not. One commenter expressed concern about improper use of DAFs by persons seeking to avoid application of the private foundation rules under Chapter 42 of the Internal Revenue Code (a support test issue).

While the Treasury Department and the IRS continue to develop proposed regulations that would, if finalized, comprehensively address donor advised funds, the recently released notice is intended to provide interim guidance on these specific issues (as stated in the previous paragraph) and to solicit additional comments in anticipation of the issuance of further guidance.

**Specific positions addressed by the IRS and the Department of the Treasury**

The following are specific positions that are being addressed by the IRS and the Department of the Treasury in their development of proposed regulations in the DAF arena. Each issue is presented below, along with a short historical summary of its application/nonapplication to the DAF environment with any suggested proposals as to how the government intends to treat such positions for tax penalty purposes as it formulates its new regulations.

**Certain distributions from a DAF providing a more than incidental benefit to a donor, donor advisor or related person**

Over the years, many practitioners have requested guidance on whether a distribution from a DAF to an organization described in section 501(c)(3) (a charity) that enables a donor, donor advisor or related person under section 4958(f)(7) (collectively referred to in the notice as a Donor/Advisor) to attend or participate in an event as a result of such distribution results in the Donor/Advisor receiving a more than incidental benefit under section 4967. Although numerous requests for this specific guidance have been received by the IRS over the years, it has been silent until now.

The IRS received many public comments in this specific area. There were suggestions that a distribution from a DAF should not be considered as conferring a more than incidental benefit as long as the amount of the distribution from the DAF does not exceed the portion of the ticket cost that would be deductible under section 170 if paid by the Donor/Advisor directly and the Donor/Advisor separately pays for the non-deductible portion.

For example, if a charity sells tickets to a charity-sponsored event for $1,000 per ticket and notifies purchasers that the fair market value of each ticket is $100, then (assuming that the requirements of section 170 are satisfied), a person who purchases a ticket for $1,000 may deduct up to $900 of the payment as a charitable contribution. Specific comments in this regard suggested that a Donor/Advisor with respect to a DAF should not be held to receive a more than incidental benefit if
the Donor/Advisor pays the $100 ticket value and the sponsoring organization, on the advice of a Donor/Advisor, distributes $900 from the DAF to the charity to pay the rest of the cost of the ticket, because the Donor/Advisor’s position is the same as if the Donor/Advisor had paid the full cost of the ticket ($1,000) and claimed a $900 charitable contribution deduction.

However, the IRS also provides its comments related to a contrary view related to an arrangement under which a Donor/Advisor pays only the nondeductible portion of the cost of a ticket to a charity event and advises a DAF distribution to pay the deductible portion of the cost of the ticket. This fact pattern suggests that such action results in a more than incidental benefit, because but for the DAF distribution the Donor/Advisor would not have received the benefits that the ticket provided. Under this viewpoint, the $900 distribution from the DAF in the example relieves the Donor/Advisor from a financial obligation that the Donor/Advisor would otherwise incur in order to receive the same benefits. As such, the position of the government is as follows:

“"The Treasury Department and the IRS currently agree that the relief of the Donor/Advisor’s obligation to pay the full price of a ticket to a charity-sponsored event can be considered a direct benefit to the Donor/Advisor that is more than incidental. Therefore, proposed regulations under section 4967 would, if finalized, provide, that a distribution from a DAF pursuant to the advice of a Donor/Advisor that subsidizes the Donor/Advisor’s attendance or participation in a charity-sponsored event confers on the Donor/Advisor a more than incidental benefit under section 4967.""

“"The Treasury Department and the IRS do not currently agree that, for purposes of section 4967, a distribution made by a sponsoring organization from a DAF to a charity upon advice of a Donor/Advisor should be analyzed the same as a hypothetical, direct contribution by the Donor/Advisor to the charity. A Donor/Advisor who wishes to receive goods or services (such as tickets to an event) offered by a charity in exchange for a contribution of a specified amount can make the contribution directly, without the involvement of a DAF.""

“"The Treasury Department and the IRS recognize that a similar issue arises if a sponsoring organization makes a distribution from a DAF to a charity to pay, on behalf of a Donor/Advisor, the deductible portion of a membership fee charged by the charity, and the Donor/Advisor separately pays the nondeductible portion of the membership fee. Therefore, The Treasury Department and the IRS anticipate that the same analysis would apply to a case where the Donor/Advisor receives these types of membership benefits, so that the sponsoring organization cannot pay the deductible portion of the membership fee without conferring more than an incidental benefit on the Donor/Advisor.""

The Treasury Department and the IRS recognize that a distribution that results in a more than incidental benefit under section 4967 may also result in an excess benefit under section 4958. The Treasury Department and the IRS anticipate that any proposed regulations would address the application of excise taxes in the case of a distribution that is potentially subject to tax under both sections 4958 and 4967. See section 4967(b). RSM will report in a follow-up white paper analysis guidance as it is made available.

**Certain distributions from a DAF permitted without regard to a charitable pledge made by a donor, donor advisor or related person**

In the absence of specific guidance and in this period of uncertainty related to DAF distributions which may be used to satisfy the personal pledge of its Donor/Advisor, many practitioners have noted that under section 4941, a private foundation’s grant or other payment in fulfillment of the legal obligation of a disqualified person ordinarily constitutes a prohibited act of self-dealing as provided in excise tax regulations section 53.4941(d)-2(f)(1). Yet still historically many others have favored allowing distributions from DAFs to fulfill a Donor/Advisor’s charitable pledge.

Some of the more practical issues related to this entire type of fact pattern would potentially be the undue burden and related complications that may be placed on a sponsoring organization to determine, before making a DAF distribution, whether a Donor/Advisor made a legally binding pledge. Legal enforceability of a so-called pledge and determining charitable intent are two issues that complicate this situation for sponsoring organizations.
Whether a given pledge is legally enforceable under state law often turns on factual details that can be difficult for the sponsoring organization to ascertain. Therefore, in the past, practitioners have noted that determining whether a pledge is legally enforceable is impractical and also places an undue administrative burden on the IRS. In addition, these practitioners comments have also suggested that distributions from DAFs to charitable organizations should be encouraged and that allowing satisfaction of Donor/Advisors’ charitable pledges facilitates the giving process. As such, the position of the government is as follows:

“Based on all these issues, The Treasury Department and the IRS currently agree with prior received public comments which suggested that it is difficult for sponsoring organizations to differentiate between a legally enforceable pledge by an individual to a third-party charity and a mere expression of charitable intent. The Treasury Department and the IRS are of the view that, in the context of DAFs, the determination of whether an individual’s charitable pledge is legally binding is best left to the distributee charity, which has knowledge of the facts surrounding the pledge. Accordingly, to facilitate distributions from DAFs to charities, the Treasury Department and the IRS are considering proposed regulations under section 4967 that would, if finalized, provide that distributions from a DAF to a charity will not be considered to result in a more than incidental benefit to a Donor/Advisor under section 4967 merely because the Donor/Advisor has made a charitable pledge to the same charity (regardless of whether the charity treats the distribution as satisfying the pledge), provided that the sponsoring organization makes no reference to the existence of any individual’s pledge when making the DAF distribution.

Specifically, it is anticipated that under this approach a distribution from a DAF to a charity to which a Donor/Advisor has made a charitable pledge (whether or not enforceable under local law) will not be considered to result in a more than incidental benefit to the Donor/Advisor if the following requirements are satisfied:

(1) The sponsoring organization makes no reference to the existence of a charitable pledge when making the DAF distribution;
(2) No Donor/Advisor receives, directly or indirectly, any other benefit that is more than incidental (as discussed in this notice and as further defined in future proposed regulations) on account of the DAF distribution; and
(3) A Donor/Advisor does not attempt to claim a charitable contribution deduction under section 170(a) with respect to the DAF distribution, even if the distributee charity erroneously sends the Donor/Advisor a written acknowledgment in accordance with section 170(f)(8) with respect to the DAF distribution.”

“Because the relationship between a private foundation and its disqualified persons typically is much closer than the relationship between a DAF sponsoring organization and its Donor/Advisors, this special rule regarding certain charitable pledges would apply for purposes of section 4967 only. The principles discussed in this section 4 would not be intended to affect the tax treatment of any item under any provision of the Code other than § 4967. As such, the holding in Revenue Ruling 81-110, 81-CB 479 (January 1, 1981) (a payment by a third party to a charitable organization that explicitly is made to pay the legally enforceable pledge of a donor is treated as a gift from the third party to the donor and then a charitable contribution from the donor to the organization); Treas. Reg. section 53.4941(d)–2(f)(1), shall remain applicable to relationships between donors and their respective private foundations.”

“For example, assume that charity Z, an organization described in sections 501(c)(3) and 170(b)(1)(A)(vi), holds an annual fundraising drive, and in response to the annual fundraising solicitation, individual B promises to contribute $1,000x to Z. B has advisory privileges with respect to a DAF and advises that the sponsoring organization distribute $1,000x from the DAF to Z. The sponsoring organization makes the advised distribution. Assume further that in its transmittal letter to Z, the sponsoring organization identifies B as the individual who advised the distribution, but makes no reference to a charitable pledge by B or any other person. Z chooses to treat the sponsoring organization’s distribution as satisfying B’s pledge. Z also publicly recognizes B for B’s role in facilitating the distribution from the sponsoring organization, but Z provides no other benefit to B. B does not attempt to claim a section 170 deduction with respect to the distribution. Under these facts, the Treasury Department
and the IRS are currently of the view that the DAF distribution does not result in a more than incidental benefit to B under section 4967 merely because Z treats the distribution as satisfying B’s pledge.”

Preventing attempts to use a DAF to avoid public support limitations

Publicly supported organizations under section 170(b)(1)(A)(vi) normally receive a substantial part of their support from governmental units and from direct or indirect contributions from the public. In determining whether an organization qualifies as publicly supported during any period, the organization generally may treat contributions (including grants) from a person as support from the general public (public support) only to the extent that such person’s total contributions to the organization during the period do not exceed two percent of the organization’s total support during the period (the two-percent public support limitation). For this purpose, all contributions made by an individual, trust or corporation and by any person or persons standing in a relationship to the individual, trust or corporation that is described in section 4946(a)(1)(C) through (G) and the related regulations are treated as made by one person. See section 1.170A–9(f)(6)(i) of the Income Tax Regulations. The two-percent public support limitation does not apply to contributions received by a donee organization from a section 170(b)(1)(A)(vi) organization, except to the extent that the contributions represent amounts earmarked by a donor to the section 170(b)(1)(A)(vi) organization as being for, or for the benefit of, the donee organization. See section 1.170A–9(f)(6)(v).

Similarly, publicly supported organizations under section 509(a)(2) cannot treat contributions from a substantial contributor as public support, but contributions from an organization described in section 170(b)(1)(A) (other than clauses (vii) and (viii)) count as public support except to the extent that the contributions received by a donee organization represent amounts earmarked by a donor to the section 170(b)(1)(A) organization as being for, or for the benefit of, a particular recipient. See section 1.509(a)–3(j).

Because of the contributions they receive from the general public, DAF sponsoring organizations typically qualify as section 170(b)(1)(A)(vi) organizations whose distributions from DAFs would ordinarily be counted as public support without limitation to the distributee charity. The Treasury Department and the IRS are aware that some donors and distributee charities seek to use DAF sponsoring organizations as intermediaries. Rather than making contributions, which would be subject to the two-percent public support limitation, directly to charities, these donors make contributions to DAFs maintained by sponsoring organizations and then advise the sponsoring organizations to make distributions from the DAFs to the distributee charities. As such, the government’s position is as follows:

“*In light of the potential for abuse, the Treasury Department and the IRS are considering treating, solely for purposes of determining whether the distributee charity qualifies as publicly supported, a distribution from a DAF as an indirect contribution from the donor (or donors) that funded the DAF rather than as a contribution from the sponsoring organization. Such treatment would better reflect the degree to which the distributee charity receives broad support from a representative number of persons.*”

Public support is defined in the regulations under sections 1.170A–9(f) and 1.509(a)–3. The Treasury Department and the IRS are considering proposing changes to these regulations to prevent the use of DAFs to circumvent the private foundation rules and excise taxes imposed by the Code by advising distributions from a DAF to a charity. It is currently anticipated that any proposed changes to these regulations would provide that a donee organization, for purposes of determining its amount of public support, must treat:

1. A sponsoring organization’s distribution from a DAF as coming from the donor (or donors) that funded the DAF rather than from the sponsoring organization;

2. All anonymous contributions received (including a DAF distribution for which the sponsoring organization fails to identify the donor that funded the DAF) as being made by one person; and

3. Distributions from a sponsoring organization as public support without limitation only if the sponsoring organization specifies that the distribution is not from a DAF or states that no donor or donor advisor advised the distribution.
The Treasury Department and the IRS recognize that a donee organization may need to obtain additional information from the sponsoring organization in order to determine its amount of public support. However, the Treasury Department and the IRS note that this additional information would only be needed if the donee organization intends to treat a distribution from a sponsoring organization as public support.

Conclusion

Although we have some guidance as to what to expect the government’s position(s) to be when it finally issues proposed regulations under section 4967, the Treasury Department and the IRS have requested further public comments regarding the following issues:

1. How private foundations use DAFs in support of their purposes
2. Whether, consistent with section 4942 and its purposes, a transfer of funds by a private foundation to a DAF should be treated as a “qualifying distribution” only if the DAF sponsoring organization agrees to distribute the funds for section 170(c)(2)(B) purposes (or to transfer the funds to its general fund) within a certain timeframe
3. Any additional considerations relating to DAFs with multiple unrelated donors under the proposed changes described in the position above related to determining public support
4. Methods to streamline any required recordkeeping under the proposed changes described in the position above related to determining public support

One good piece of information is that the Treasury Department and IRS have stated that taxpayers may rely on the rules described in Notice 2017–73 until future guidance is issued.

Notice 2017–73 is a great start to the highly anticipated proposed regulations under section 4967 related to DAFs and distributions from such accounts. Although the Treasury Department and IRS’s positions are those that were anticipated, by providing the general public with this guidance quite a lot of uncertainty has already been removed in an area strewn with landmines and lack of direct guidance. RSM will keep you updated on developments as they occur and provide an analysis of the proposed regulations under section 4967 as they are made public.