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Donor-Advised Funds and Understanding the Proposed IRC §4966 Regulations

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Late last year, the Internal Revenue Service (IRS) released its proposed regulations under the Internal Revenue Code (IRC) §4966. In this bulletin, we will update you on the key provisions of the IRS proposal and share some key considerations for private foundations and their managers.

Overview

Initially enacted in 2006, the IRS now seeks to introduce new provisions to IRC §4966 focusing on excise taxes on taxable distributions made by sponsoring organizations from a Donor-Advised Fund (DAF), and on the agreement of certain fund managers to the initiation of such distributions. The proposed regulations would generally apply to community foundations, private foundations and other charitable organizations that maintain DAFs, as well as the persons involved with the DAF, including donors and DAF managers.

Key Provisions

Following are key provisions that lay the foundation for understanding the implications of IRC §4966.

Definition of Donor-Advised Funds

The proposed regulations provide a comprehensive definition of DAFs, emphasizing their unique structure and purpose. DAFs allow donors to make irrevocable contributions while retaining advisory privileges over the distribution of funds to charities. A DAF – generally as a fund or account – would be defined as the following:

- that is separately identified by reference to contributions of a donor or donors,
- that is owned and controlled by a sponsoring organization, and
- with respect to which a donor (or any person appointed or designated by the donor, namely, a donor-advisor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of the donor's status as a donor.

Excise Tax on Taxable Distributions

IRC §4966 outlines a set of taxable distributions, which, if undertaken by a private foundation, could trigger excise taxes. The excise tax imposed would be a 20% tax on each taxable distribution, which would be payable by the sponsoring organization with respect to the DAF, i.e., the foundation.

The proposed regulations define a taxable distribution as the following:

- any distribution from a DAF to any natural person,

- a distribution from a DAF to any other person if the distribution is for any purpose other than a purpose specified, or
- the sponsoring organization does not exercise expenditure responsibility with respect to the distribution.

Excise Tax on Agreement of Fund Manager

In addition to the excise taxes imposed on individual taxable distributions made from a DAF, the proposed regulations would impose a 5% excise tax on the agreement of a DAF manager, *"to the making of a taxable distribution knowing that it is a taxable distribution, payable by any DAF manager who agreed to the making of the distribution."*

The regulations define a fund, or DAF manager, with respect to any sponsoring organization as the following:

- an officer, director, or trustee of such sponsoring organization – or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the sponsoring organization, and
- with respect to any act (or failure to act), the employees of the sponsoring organization having authority or responsibility with respect to each act (or failure to act).

Important Factors for Private Foundations and DAF Managers

Grantmaking Due Diligence

Sponsoring organizations, including private foundations overseeing DAFs, must exercise due diligence in evaluating all grant requests. The proposed regulations emphasize that grants from DAFs should align with the foundation's mission and should carefully consider the impact of the proposed regulations so as to avoid a taxable distribution from the foundation. A comprehensive vetting process and clear grantmaking guidelines can help foundations navigate this aspect successfully. A thorough review of the foundation's grantmaking policy manual must be part of the due diligence process.

Documentation

Meticulous record-keeping is vital for private foundations with DAFs. Administrators should maintain detailed documentation of grants, contributions and distributions. This expedites compliance with the proposed regulations and serves as a valuable resource during IRS audits. Clear documentation helps foundations demonstrate that their activities adhere to the tax code.

Educational Efforts for Donors

Well-informed donors are more likely to contribute in a manner consistent with the foundation's compliance goals. Private foundation administrators are highly encouraged to engage in educational efforts directed toward donors involved in DAFs. Clear communication regarding the regulations governing DAFs, the tax implications of contributions and the foundation's mission can help bring in line donor expectations with regulatory requirements.

Professional Guidance and Legal Counsel

Given the intricate nature of the proposed regulations, private foundations should seek advice from their tax practitioners and legal counsel. Experienced tax practitioners and attorneys can provide insights into the nuances of the regulations, offering tailored guidance to ensure compliance. Legal expertise is particularly valuable when configuring complex grants or navigating potential gray areas in the tax code.

Conclusion

Private foundation administrators piloting the landscape of IRC §4966 and its proposed regulations must pay special attention to the unique challenges posed by DAFs. By conducting due diligence in grantmaking, maintaining meticulous records, educating donors and seeking professional advice, administrators can position their foundations to successfully comply with the regulations while continuing to advance their philanthropic missions through DAFs. Effective compliance safeguards the tax-exempt status of private foundations and ensures their lasting impact on the charitable landscape.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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