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Proposed Regulations on Donor Advised Funds: Take-Aways for Impact Investing

In November, the Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") released the first set of **proposed regulations** providing guidance on the federal tax rules governing donor-advised funds ("DAFs"). We will be posting a series of blog posts with our thoughts on different aspects of these proposed regulations.

As DAFs continue to grow, the capital available for impact investing is significant. Both DAF sponsoring organizations and donors have expressed interest in putting these funds to work through investments that have a mission-related purpose. However, while the Internal Revenue Code defines program-related investments ("PRIs") for private foundations, the guidance is less clear on how to treat a similar investment out of a DAF.

So what did we learn from the proposed regulations regarding DAFs and impact investments?

Investments are not distributions, but we don't know where the line is yet. The preamble to the proposed regulations states that investments generally would not be treated as distributions from a DAF because they "typically merely reflect a change from one form of property to another." The Treasury and the IRS would consider investments for this purpose as including both debt and equity instruments held for the purpose of generating income, including investments made "partly for charitable purposes" as described in IRS Notice 2015-62. Often referred to as "mission-related investments," these are investments that help further a charity's exempt purpose but do not qualify as PRIs. (See our blog on IRS Notice 2015-62 **here**.)

If an investment is not a distribution, then certain tax code provisions do not apply. In particular, an investment does not require expenditure responsibility by the sponsoring organization. This should make these investments easier to make and perhaps sponsoring organizations more willing to make them.

What about an investment that *would* qualify as a PRI, which is an investment made primarily to accomplish a charitable purpose and not to generate a financial return? Should these investments be considered distributions?

The Treasury and the IRS clarify that an investment would not, for example, include a zero-interest loan, "as there is no purpose of, or provision for, obtaining income or funds from the zero-interest loan." The Treasury and the IRS therefore anticipate that a zero-interest loan would be a distribution under the proposed regulations and would require expenditure responsibility. Beyond that, we do not yet have further guidance; the Treasury and the IRS have requested comments on how to further distinguish

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distributions from investments. (**Comments are due** by February 15th.)

No zero-interest loans to individuals. We do know that DAFs cannot make distributions to individuals. Because a zero-interest loan would be considered a distribution, a DAF would not be used, for instance, to make zero-interest loans to students to buy books or to individuals for other purposes who are in need of financial support. The proposed regulations also provide that if expenditure responsibility applies to a DAF distribution, then the recipient must agree not to use the funding to make any grant to a natural person. We do not know yet whether below-market loans might also be considered a distribution and therefore not permissible to individuals.

Expenditure responsibility could apply; consider a public charity intermediary. Until we have further guidance, a sponsoring organization may wish to exercise expenditure responsibility over investments that could meet the definition of a PRI. One reason is that the proposed DAF regulations cross-reference the expenditure responsibility regulations applicable to private foundations, and PRIs are included in the definition of grants to which these expenditure responsibility rules apply. Alternatively, the DAF could make a grant or loan to a public charity that would make further distributions. Grants and loans to public charities do not require expenditure responsibility, and the public charity could have greater flexibility in deciding how to use the funds to further its charitable purposes, including through PRIs.

Reasonable investment fees generally are not distributions. Under the proposed regulations, "distribution" means any grant, payment, disbursement, or transfer, whether in cash or in kind, from a DAF. However, investments and reasonable investment-related fees (and grant-related fees as well) are not considered distributions. Therefore, while the proposed regulations might make other DAF payments to non-charities more complicated because they will require expenditure responsibility, payment of investment-related fees would not be subject to this requirement.

However, the donor's investment advisor cannot be paid from the DAF. Under the proposed regulations, an investment advisor who manages the investment of, or provides investment advice with respect to, both the assets maintained in a DAF and the personal assets of a donor to that DAF will be treated as a donor-advisor with respect to the DAF while serving in that dual capacity, regardless of whether the donor appointed, designated, or recommended the advisor. (An exception is included if the advisor provides services to the sponsoring organization as a whole.) Section 4958 of the Internal Revenue Code provides that any grant, loan, compensation, or other similar payment from a DAF to a donor-advisor is automatically deemed an excess benefit transaction and subject to excise taxes. This means that a donor's personal investment advisor cannot be paid from the DAF for the investment services they provide to the DAF.

More to come. Next up... Fiscal Sponsorship and DAF Advisory Privileges

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