

IMPACT INVESTING THROUGH A DONOR-ADVISED FUND

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The donor-advised fund (DAF) is a rapidly growing vehicle for charitable giving in the United States. The National Philanthropic Trust estimates that assets held in DAF accounts in 2012 exceeded \$45 billion, growing by \$7.21 billion in that year alone.¹ The NPT Report estimated that in 2012 national charities that sponsor DAFs (charities considered to have a national reach in fundraising and grant-making) received \$6.53 billion in contributions, while community foundations that sponsor DAFs received \$4.28 billion. The NPT Report also found that the average DAF account size in 2012 was \$224,921, an increase of 11.2% over the year before. The capital potentially available for impact investments is significant.

A DAF is a separate fund but not a separate legal entity. It is created and held at a public charity sponsor, often referred to as the sponsoring organization. The sponsoring organization typically is a local community foundation or the charitable affiliate of a financial services provider. A donor contributes funds or assets to the sponsoring organization, which holds

them in a DAF. The donor could be an individual, a company, or another charity, such as a private foundation. The donor can take a charitable contribution deduction in the year in which the contribution is made because the donated assets become the property of the sponsoring organization upon donation. A donor that is a private foundation can count the contribution as a qualifying distribution in the year of the contribution.

The donor, or someone appointed by the donor, retains the right to advise or recommend charitable grants from the DAF from time to time. The sponsoring public charity is the legal owner of the funds and has “discretion and control” over those assets, meaning that the sponsor ultimately makes grant decisions and is not required to follow the advice of the donor.

In addition to recommending grants, donors sometimes also have an opportunity to recommend how DAF money should be invested. Some DAF sponsoring organizations include mission-related, or “impact,” investment options. Sponsoring organizations may offer mission-related allocations within existing general investment pools, investment pools specifically dedicated to a mission-related purpose, or in some instances individual invest-

If the IRS distinguishes program-related investing from other types of investing, as it does for private foundations, certain tax rules may apply.

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ments. Sponsoring organizations may view these investment options as another means of providing donors with an opportunity to further the social missions they care about.

A mission-related or impact investment can be defined broadly as a financial investment that also furthers a social or environmental purpose. Any investment by which the investor intends to generate both a social or environmental return as well as a financial return, so that it is not exclusively about profit, might qualify. Impact investments can be made in the form of equity, debt, loan guarantees, or other market instruments. Despite current common usage, there is no legal definition of a mission-related or impact investment, and no legal requirements to qualify for this status.

While sponsoring organizations may offer mission-related investment options, tax guidance in this area is sparse. Certain federal tax rules apply to DAFs that do not apply to public charities in general, and these rules affect how investments can be made. There is IRS guidance regarding how private foundations may engage in charitable program-related investing, but it is not known yet if or how the IRS will implement a similar charitable investment standard for DAFs. If the IRS considers some category of program-related investing to be charitable, as it does for private foundations, certain tax rules may apply (e.g., expenditure responsibility). On the flip side, if an investment does not qualify as a charitable program-related activity, the investment likely needs to meet the same prudent investment standards that apply to any other commercial investment. Nevertheless, some impact investment opportunities appear to offer "concessionary" or

below-market risk-adjusted returns, in support of mission.

Federal tax law background of donor-advised funds

The Code did not include a definition of a DAF until the Pension Protection Act of 2006 (PPA), but DAFs have existed in practice for some time. The term "was commonly understood to refer to an account established by one or more donors but owned and controlled by a public charity to which such donors or other individuals designated by the donors could provide nonbinding recommendations regarding distributions from the account or regarding investment of the assets in the account."²

In light of concerns that DAFs were being "established for the purpose of generating questionable charitable deductions, and providing impermissible economic benefits to donors and their families,"³ Congress included restrictions in the Code governing the activities of DAFs and their sponsors in the PPA. As yet there are no Treasury regulations interpreting these Code provisions, and it is unclear when this guidance may be coming.

Definition of a donor-advised fund. Section 4966(d)(2), added by the PPA, defines a DAF to mean a fund or account that is (1) separately identified by reference to contributions of a donor or donors, (2) owned and controlled by a sponsoring organization, and (3) with respect to which the donor, or any person appointed or designated by such donor (the "donor advisor"), has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the fund by reason of the donor's status as a donor. All three prongs must be met to qualify as a DAF.

¹ See National Philanthropic Trust, "2013 Donor-Advised Fund Report" (hereinafter, "NPT Report"), available at www.nptrust.org/daf-report/. The National Philanthropic Trust "studied 1,007 charitable organizations that administer donor-advised funds. Data in [the] report come primarily from public information returns (IRS Form 990), which fund sponsors filed with the IRS. Additional data came from audited financial statements, annual reports, organizational websites and news releases." See also Department of Treasury, "Report to Congress on Supporting Organizations and Donor Advised Funds, December 2011," available at <http://www.treasury.gov/resource-center/tax-policy/Documents/Supporting-Organizations-and-Donor-Advised-Funds-12-5-11.pdf>. ("IRS data indicate that in tax year 2006, the 2,398 DAF sponsoring organizations had 160,000 DAFs. The assets in these DAFs were valued at \$31.1 billion as of the end of tax year 2006.")

² See Notice 2006-109, 2006-2 CB 1121.

³ See www.irs.gov/Charities-%26-Non-Profits/Charitable-Organizations/Donor-Advised-Funds.

⁴ Section 4966(d)(1).

⁵ That is, any purpose other than one specified in Section 170(c)(2)(B).

⁶ A person described in Section 4958(f)(7) with respect to the DAF.

⁷ Section 4967(a)(2), Section 4967(c)(2).

⁸ Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," As Passed by the House on July 28, 2006, and As Considered by the Senate on August 3, 2006* (the "JCT Report"; JCX-38-06) page 350.

⁹ Section 4958(f)(3)(B). These assets include "pools of assets all or part of which are attributed to donor advised funds." JCT Report, *supra* note 8 at 348.

¹⁰ The JCT Report explains that "other similar payments" include payments "in the nature of" a grant, loan, or payment of compensation, including expense reimbursement. Other similar payments do not include, however, "a payment pursuant to bona fide sale or lease of property, which instead are [sic] subject to the general rules of section 4958." JCT Report, *supra* note 8 at page 347.

A sponsoring organization must be an organization described in Section 170(c) that is not a governmental organization (referenced in Sections 170(c)(1) and (2)(A)) or a private foundation.⁴

Taxable distributions. Section 4966 imposes an excise tax on sponsoring organizations equal to 20% of the amount of each taxable distribution that the organization makes from a DAF. The Code also imposes an excise tax of 5% on any fund manager of the sponsoring organization who agrees to make a distribution knowing that it is a taxable distribution.

Under Section 4966(c)(1), a distribution from a DAF to any natural person is a taxable distribution. A distribution to any recipient other than a natural person will be taxable if the distribution (1) is for a non-charitable purpose,⁵ or (2) is to an entity that is not described in Section 170(b)(1)(A) and the sponsoring organization does not exercise expenditure responsibility with respect to such distribution in accordance with Section 4945(h).

Notwithstanding Section 4966(c)(1), Section 4966(c)(2) provides that taxable distributions do *not* include distributions from a DAF to (1) any organization described in Section 170(b)(1)(A) (public charities and private operating foundations) other than certain disqualified supporting organizations, (2) the sponsoring organization, or (3) any other DAF.

Therefore, a sponsoring organization can make grants from a DAF to most public charities. The sponsoring organization can also make grants from a DAF to other types of grantees (other than individuals), *provided* the grant is for charitable purposes *and* the sponsoring organization exercises expenditure responsibility over the grants. The Code applies the expenditure responsibility rules written for private foundations to DAFs, without any explanation of how expenditure responsibility may differ in the DAF context. Such an explanation awaits future regulations.

Certain benefits prohibited. Section 4967 imposes an excise tax "on the advice" of the donor, any person appointed or designated by the donor, or certain other people, to have a sponsoring organization make a distribution from a DAF that results in any of those people "receiving, directly or indirectly, a more than incidental benefit as a result of such distribution." The "certain other people" referred to above includes certain family members and entities that are 35%-controlled by donors and family members.⁶ The tax is equal to

125% of the benefit and is levied on any such person who advises as to the distribution or who receives the benefit as a result of the distribution. If more than one person is liable for the tax imposed, all are jointly and severally liable. If a tax on the distribution is imposed under Section 4958 (see below), however, no tax will be imposed under Section 4967.

Any fund manager that agrees to making such a distribution, knowing that it will confer a more-than-incidental benefit, is subject to a 10% excise tax on the amount of the benefit, not to exceed \$10,000 with respect to any one distribution.⁷

The legislative history of the PPA provides that there is a more than incidental benefit under Section 4967 if, as a result of a distribution from a DAF, a donor or advisor receives a benefit that would have reduced a charitable contribution deduction if the benefit was received by the donor or advisor as part of the contribution.⁸

Excess benefit transactions involving DAFs or investment advisors. Section 4958, which imposes taxes on excess benefit transactions, includes a category of disqualified persons with respect to DAF donors and donor advisors. For transactions involving a DAF, disqualified persons under Section 4958 include donors (or any people appointed or designated by the donor) who have advisory privileges, certain of their family members, and certain 35%-controlled entities related to them.

For transactions involving a sponsoring organization (but not necessarily a DAF), "disqualified person" also includes an investment advisor with respect to the sponsoring organization, family members of the advisor, and "35-percent controlled entities" of the investment advisor. "Investment advisor" means, with respect to any sponsoring organization, any person, other than an employee of the sponsoring organization, compensated by the sponsoring organization "for managing the investment of, or providing investment advice with respect to, assets maintained in" DAFs owned by the sponsoring organization.⁹

Section 4958 imposes an excise tax on any distribution that constitutes an excess benefit transaction. Any grant, loan, compensation, or other similar payment from a DAF to a donor advisor disqualified person is automatically deemed an excess benefit transaction. The excess benefit is the entire amount of the grant, loan, compensation, or other payment.¹⁰

In addition to these automatic excess benefit transactions, any other transaction involving either (1) a donor advisor disqualified person and the respective DAF (though not necessarily with the sponsoring organization outside of the DAF) or (2) an investment advisor and the sponsoring organization (not necessarily involving any specific DAF) is subject to the general rules under Section 4958 governing excess benefit transactions (e.g., taxes imposed on any amount paid to the disqualified person that is deemed "excessive").

Excess business holdings. The PPA extended the private foundation excess business holdings rules to DAFs. As a general matter, a DAF and its disqualified persons together may own no more than 20% (in some cases, 35%) of the voting or ownership interest in a business enterprise.¹¹ "Disqualified persons" for these purposes include a donor advisor, his or her family members, and entities 35%-controlled by either.¹² This restriction on business holdings can limit a DAF and its disqualified persons together from owning more than a certain percentage of the voting shares of a business corporation or of the profits interest in a partnership or limited liability company.

Form 990 reporting. Sponsoring organizations are required to report on Form 990 the total number of DAFs held, the aggregate value of assets held in DAFs, and the aggregate contributions to and grants from DAFs during the tax year. In addition, certain transactions described above may need to be reported and therefore publicly disclosed. For instance, a sponsoring organization that makes a taxable distribution must disclose it on Part V, Line 9 of its Form 990. In addition, an organization that engages in an excess benefit transaction must disclose the transaction on Part

IV, Line 25 of its Form 990 and provide details regarding the transaction in Part I of Schedule L.

What are the rules regarding DAF investments?

Investments typically are subject to state prudent investor rules.

State corporate law. The corporate law in each state may set forth a specific standard for directors making investments on behalf of a nonprofit corporation. For instance, charities in California are governed by the "prudent person" investment rule: in investing, reinvesting, purchasing, or acquiring, exchanging, selling, and managing the corporation's investments, directors must "avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income as well as the probable safety of the corporation's capital."¹³ This standard does not apply to "assets which are directly related to the corporation's public or charitable programs."¹⁴

The Uniform Prudent Management of Institutional Funds Act. Almost all states have adopted some version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which includes a fiduciary standard for the management and investment of institutional funds. This investment standard applies to all institutions, not just charities with an endowment.

Under UPMIFA, the standard for prudent investment is as follows:

[E]ach person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.¹⁵

UPMIFA applies the "modern portfolio investment theory" in its fiduciary standard for the management and investment of institu-

¹¹ The term "business enterprise" is defined in Section 4943 and Reg. 53.4943-10. Certain businesses are not included in this definition; in particular, those that are "functionally related" to the foundation's exempt purposes or that have gross income derived from passive sources.

¹² See Section 4943(d)(1), Section 4946.

¹³ California Corporations Code § 5240. For charities formed as trusts rather than corporations, trust law instead of corporate law would provide the applicable prudent investor standard.

¹⁴ California Corporations Code § 5240(a).

¹⁵ UPMIFA § 3(b).

¹⁶ UPMIFA § 3(e)(1)(H).

¹⁷ The National Conference of Commissioners on Uniform State Laws (NCCUSL) published an article specifically addressing the meaning of the term "program-related asset." See "Program-Related Assets Under UPMIFA", available at www.uniformlaws.org/Shared/Docs/Prudent%20Mgt%20of%20Institutional%20Funds/UPMIFA%20Program%20Related%20Assets%20Article.pdf (last visited 1/19/14) ("NCCUSL Article").

¹⁸ UPMIFA § 2(7).

¹⁹ See, for instance, section 5240 of the California Corporations Code, described above (fiduciary standard does not apply to assets "which are directly related to the corporation's public or charitable programs." California Corporations Code § 5240(a)).

²⁰ See NCCUSL Article ("The exclusion for program-related assets applies to tangible or real assets held by a charity for direct use in its charitable activities and, for a charity engaged in micro-finance as its charitable purpose, to a fund used to make loans.") This description seems narrower than the range of passive investments that might be considered mission related. The NCCUSL Article also notes that "an asset may have a mixed purpose and determining whether the asset is a program-related asset may be more difficult."

²¹ See UPMIFA § 3(a); see also NCCUSL, "UPMIFA with Prefatory Note and Comments," page 15 ("Subsection (a) states the overarching duty to comply with donor intent as expressed in the terms of the gift instrument.").

²² UPMIFA § 3(e).

²³ See *Styles v. Friends of Fiji*, No. 51642 (Nev., 2011) (unpublished opinion).

tional funds by nonprofit corporations. Therefore, decisions about an individual asset are to be made in the context of the portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the organization. No type of investment is *per se* deemed imprudent under UPMIFA but, absent special circumstances, an organization must diversify its investments.

UPMIFA enumerates certain specific factors that, if relevant, a charity must consider in making an investment decision. In addition to considerations like the expected total return and the organization's need to preserve capital, these factors also include "an asset's special relationship or special value, if any, to the charitable purposes of the institution."¹⁶ According to the Uniform Law Commission, which drafted it, UPMIFA "does not preclude a charity from acquiring and holding assets that have both investment purposes and purposes related to the organization's charitable purposes."¹⁷

This last factor is particularly important for mission-related investing. What is not stated is how much weight the relationship to charitable purpose can be given compared to the other factors. However, because UPMIFA looks at the organization's investments as a whole, certain higher-risk investments that perhaps would not be prudent if they made up a large part of a portfolio may contribute to diversification and balance out other risks when made as a smaller allocation.

Program-related assets. UPMIFA does not apply to "program-related assets," which are defined as assets held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment.¹⁸ Similarly, the prudent investment standard under other state law provisions may exclude charitable assets.¹⁹ It is not clear how broad an exception these state laws provide for an impact investment to avoid scrutiny under a prudent investment standard.²⁰

Donor intent. A charity must make investment decisions consistent with donor intent.²¹ UPMIFA's prudent investment standards, including diversification requirements, apply to institutional funds "[e]xcept as otherwise provided by a gift instrument."²² Therefore, even if certain investments do not qualify as program-related assets, UPMIFA's prudent investment standard will not apply if the DAF agreement includes language in which the donor expresses an intent that funds be

used for specific mission-related investments or investment classes.

How does UPMIFA apply to DAF investments? A question specific to DAFs is whether an investment must be deemed prudent in view of the overall assets of the DAF sponsoring organization or with respect to each individual DAF. The definition of an "institutional fund" under UPMIFA, which does not specifically address DAFs, seems open to the latter possibility. To the extent a sponsor segregates a DAF and makes investments separately from other DAFs, rather than pooling the different funds, a state attorney general may be more likely to treat the individual DAF as an "institutional fund" and ask whether the investment was prudent when viewed with respect only to the other assets of that fund. This would mean that each investment is likely to make up a much larger percentage of the portfolio's overall assets, and affect whether or not the goal of a diversified portfolio has been met. Until there is further guidance, the safest practice is to strive for diversification on the individual DAF and the sponsoring organization levels.

When considering impact investments that may present a higher risk of loss, one issue is whether a claim might be made that the managers of the sponsor violated their fiduciary duty by not properly diversifying the individual fund. It seems unlikely that a donor would have a claim, because the donor no longer owns the contributed assets in the DAF.²³ However, an attorney general would have jurisdiction and could look into this question. If an unhappy donor observes a significant investment loss depleting the DAF created by the donor, he or she might look for leverage through filing a complaint with the attorney general, even if the donor has no personal claim of harm as a result of the loss.

As described above, donor intent can override the statutory investment considerations. A sponsoring organization therefore should clearly document this intent. It may not be sufficient, however, for the intent to be expressed by a financial advisor who ultimately is engaged by the sponsoring organization, even if he or she was referred by and is someone with whom the donor regularly consults. The sponsoring organization would be better off having an explicit statement of donor approval of a specific investment or type of investment directly from the donor. A sponsoring organization might decide to document donor intent in this way only in extraordinary circumstances

(e.g., a large investment made pursuant to non-standard investment criteria). The sponsoring organization might reduce risk by obtaining a letter from the donor at the time of the contribution authorizing the specific investment that the sponsoring organization might not otherwise make.

The sponsoring organization also should consider whether decisions regarding an individual DAF are consistent with the sponsoring organization's existing investment policy. Investment decisions outside of its policy might be more likely to be viewed as imprudent. In addition, the Council on Foundations has suggested that allowing a donor to recommend an investment advisor *and* an investment strategy outside of the sponsoring organization's standard investment policy could be viewed as too much donor control over the DAF.²⁴

Program-related investments. The Code recognizes that certain investments in private entities by charitable organizations may legitimately serve charitable purposes. Private foundations can rely on the definition in Section 4944 of a "program-related investment" (PRI) that carves these investments out of the jeopardizing investment rules prohibiting certain types of risky investments. A PRI is a charitable investment that is closely akin to a charitable grant.

In order to qualify as the PRI of a private foundation, an investment must meet a three-part test: (1) the primary purpose of the investment must be to further one or more exempt purposes of the foundation, (2) the production of income or the appreciation of property may not be a significant purpose of the investment, and (3) no electioneering and only very limited lobbying purposes may be served by the investment. This test applies only to private foundations, however. There is no parallel statutory definition of a program-related investment for a public charity, including DAF sponsoring or-

ganizations, that explicitly classifies these investments as charitable.

If a PRI is a permissible charitable activity for a private foundation, it seems reasonable to conclude that similar investments are permissible for other types of tax-exempt organizations that are less heavily regulated than private foundations under the Code. Public charities, for instance, also should be able to follow precedent that has been established for private foundations indicating when an investment is primarily for charitable purposes.

The Form 990 filed annually by public charities, including DAF-sponsoring organizations, recognizes that filing organizations may make program-related investments. The balance sheet in Part X, line 13 of the Form 990, for instance, includes a separate line item for "program-related investments," and related expenses are reported in Part IX of the return.²⁵ The Form 990 instructions define program-related investments as "those investments made primarily to accomplish the organization's exempt purposes rather than to produce income." This is similar (but not identical) to the PRI definition in Section 4944.

For private foundations, PRIs include certain tax advantages that do not apply to most public charities. For instance, PRIs can count as qualifying distributions that help meet the foundation's annual minimum payout requirement, and equity PRIs are exempt from excess business holding restrictions. While most public charities do not need to worry about such things, DAFs are now subject to some rules that previously applied to only private foundations, such as expenditure responsibility.

May program-related investments be made through a DAF? As explained above, the definition of a PRI exists in Section 4944 as an exception to the private foundation jeopardizing investment rules. Section 4944 does not apply to public char-

²⁴ According to Suzanne S. Friday, legal counsel at Council on Foundations: "Although we don't have specific guidance on this exact question, I think that allowing a donor to recommend an advisor and an investment strategy outside your normal investment policy would be viewed as too much donor control over the DAF. However, if you change your policy so that the investment manager is acting within parameters you have set (and thereby allow other managers to do the same), you appear to retain ultimate control. See also Council on Foundations, "Working with a Donor's Investment Manager," Kelly Shipp Simone (2010).

²⁵ See also Form 990, Part IV, Line 37 (in defining an exception to the reporting of a related organization, the filing organization does not need to report if its investment in a partnership is the production of income or appreciation of property "and not the conduct of section 501(c)(3) charitable activity such

as program-related investing"); Part VIII, Lines 7a-7c (reporting sales from non-inventory assets, such as program-related investments).

²⁶ The JCT Report repeats the expenditure responsibility language, substituting the word "distribution," in reference to a DAF distribution, for the word "grant." See JCT Report, *supra* note 8 at 349.

²⁷ IRS Notice 2006-109, 2006-2 CB 1121.

²⁸ ABA Tax Section, "Comments in Response to IRS Notice 2006-109 on the Application of the Pension Protection Act of 2006 to Donor Advised Funds and Supporting Organizations," page 34, available at www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2007/070604irsnotice2006109.authcheckdam.pdf.

²⁹ Section 4966(c)(1)(B)(ii).

³⁰ Section 4945(h).

ities, and no other statute carves out program-related investments as a charitable activity for them. The PPA, however, applies the private foundation expenditure responsibility rules to DAFs, and these rules do take PRIs into account.²⁶ It is as yet unknown whether expenditure responsibility as applied to DAFs will also include some version of a program-related investment. If existing Treasury regulations for private foundations ultimately are adapted in large part for interpreting expenditure responsibility for DAFs, it seems possible that some DAF investments could be characterized as program-related and viewed as akin to private foundation PRIs (and therefore subject to expenditure responsibility requirements, discussed below).

On the other hand, the IRS might not treat any investments by a DAF as charitable, despite the fact that other charities can and do make investments primarily for a charitable purpose. The IRS might view a DAF program-related investment as being like any other investment and not as a distribution to a non-charitable entity that requires expenditure responsibility. Whether or not the IRS will distinguish program-related investments from other investments, as PRIs are distinguished for private foundations, will not be known until the IRS issues further guidance.

The Code does not impose any excise tax on public charities that make imprudent investments as it does on private foundations under Section 4944. In addition, DAF sponsors are not (currently) subject to minimum distribution requirements that make PRI qualification important for private foundations. Therefore, the most significant concern regarding whether a DAF investment might be considered program-related may be whether an attorney general will be more likely to deem the investment as exempt from the state law prudent investor standards described above.

Other federal tax law considerations

In addition to the specific issues discussed above pertaining to DAF investments, the provisions in the Code addressing DAFs raise other, more general questions.

What is a distribution? Section 4966 does not define the term “distribution.” However, the section does distinguish “distribution” from the term “investment.” Shortly after enactment of the PPA, the IRS issued a Notice providing certain interim guidance regarding DAFs, and requesting sugges-

tions for future guidance.²⁷ One subject on which practitioners have requested guidance is the term “distribution.”²⁸

Until regulations are issued, other sections of the Code might provide guidance to determine the meaning of “distribution.” For instance, a loan or an equity investment by a private foundation that qualifies as a PRI can constitute a “qualifying distribution” for purposes of the Section 4942 minimum distribution requirement applicable to private foundations.

If the payment constitutes a distribution and it is not a permitted distribution, it will be taxable under Section 4966. For instance, a no-interest or very low-interest loan, or a type of loan that has a very low repayment rate, if made for a mission-related purpose, might constitute a distribution within the meaning of Section 4966 rather than an investment. Because DAF distributions to individuals are not permitted, this interpretation could restrict for instance, most forms of microfinance, in which lenders make loans to low-income individuals at below-market rates. Also, if the loan recipient is not a public charity, expenditure responsibility would be necessary. The sponsoring organization will want to be sure that an investment made through a DAF will not constitute a taxable distribution.

How should expenditure responsibility apply to a DAF? Certain distributions for which the sponsoring organization does not exercise expenditure responsibility are taxable distributions.²⁹ Expenditure responsibility is a process of due diligence and oversight imposed by Section 4945(h) on private foundations that Section 4966 incorporates by reference. Because Section 4945(h) and the regulations promulgated thereunder were written for private foundations, it is not yet clear how certain aspects of these regulations will apply to DAFs. Nevertheless, the Section 4945(h) regulations currently provide the best guide for how a DAF should conduct expenditure responsibility.

When a private foundation makes a grant to or a PRI in a noncharitable entity, the foundation must exercise expenditure responsibility or it will have made a taxable expenditure. It is the private foundation’s responsibility “to exert all reasonable efforts to establish adequate procedures (1) to see that the grant is spent solely for the purpose for which it is made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports [to the IRS].”³⁰ This over-

sight requirement consists of a "pre-grant inquiry," a written agreement containing specific terms, receipt of certain reports from the recipient, and grant/PRI reporting to the Service on Form 990-PF. The regulations describe requirements for the contents of a written investment agreement and for the frequency and types of reporting for PRIs that are distinct from the expenditure responsibility requirements that apply to grants made to noncharitable entities.

Absent DAF regulations, the law is not clear whether this distinction applies to DAFs and whether an investment by a DAF made for charitable purposes would need to include certain terms in the written agreement. In addition, the expenditure responsibility regulations require a different list of prohibited activities for grants than they do for PRIs. When the IRS issues regulations governing DAFs, it is possible that the regulations will not follow the distinction between grants and PRIs that exists for private foundations. If, by virtue of a different distinction, or no distinction at all, the IRS treats certain charitable investments as distributions and requires expenditure responsibility analogous to that which is currently required for grants, the agreement may need to require the grantee not to distribute funds in a manner in which the grantor itself cannot distribute funds, as is required for private foundation expenditure responsibility grants. If the IRS follows a similar approach with the DAF regulations, the regulations could require a recipient to agree not to loan funds to natural persons, for instance, as a DAF could not make such a distribution directly.

Restrictions on equity investments. DAF equity investments are subject to excess business holding restrictions, as described above. The regulations exempt private foundation PRIs from these excess business holding rules. Until there is guidance from the Service, whether DAFs will receive a similar exception for program-related investments will remain unclear. Therefore, any DAF equity investment for the time being should observe the excess business holding limitations.

To avoid excess business holding concerns, a sponsor might limit DAF impact investment options to loans or other non-equity investments.

Other considerations for DAF impact investing

Impact investments also raise issues beyond the DAF rules. Below are some other areas sponsoring organizations should consider.

UBIT. DAF investments are subject to the federal tax rules regarding unrelated business income tax (UBIT). Mission-related investments would avoid UBIT if they qualify as "substantially related" to the charity's exempt purposes. In some situations, an impact investment might be considered substantially related (e.g., an investment that would qualify as a PRI under Section 4944). However, this conclusion seems less likely for an investment that does not qualify as a PRI (i.e., when the charitable purpose is not clearly primary and a return on investment might be considered a significant purpose).

To avoid UBIT, an impact investment may need to meet a statutory exception. For instance, dividends paid on shares of stock, income allocated to a holder of an interest in a limited partnership that itself only holds passive investments, and capital gains on non-inventory assets may meet the exception for passive investment income, and therefore not be taxed. However, the rules governing debt-financed income and the use of acquisition indebtedness then come into play; investment income generated through assets that are acquired with debt do not fully qualify for a statutory exception to UBIT. Determining the consequence of UBIT liability as result of acquisition indebtedness under the Code's debt-financed income rules can be a complicated matter.

The sponsoring organization would be responsible for reporting and paying any UBIT, although the tax presumably would be allocated to the individual DAF from which the investment was made.

Excess benefit when a disqualified person is involved. Section 4958 imposes an excise tax on any distribution that constitutes an excess benefit transaction. Any grant, loan, compensation, or other similar payment from a DAF to a donor advisor disqualified person, as explained above, is automatically deemed an excess benefit transaction, and the excess benefit is the entire amount of the grant, loan, compensation, or other payment. Therefore, any DAF investment vehicle may need to avoid any payment or loan to a donor advisor disqualified person. For instance, if the donor is a general partner in, or an advisor to, an investment vehicle and receives compensation in this role, the DAF as an investor could be

³¹ See, e.g., Ltr. Rul. 200551025, Ltr. Rul. 200420029, and Ltr. Rul. 200043047.

³² See, e.g., California Financial Code, Division 9 (commencing with Section 22000).

deemed to be providing some level of compensation to the donor advisor. In addition, to the extent any DAF disqualified person will be involved, Section 4958 in general may apply (e.g., even if there is no automatic excise tax, there could still be a financial benefit to the disqualified person that might be deemed excessive).

Co-investment. The situation may arise in which the donor advisor personally wishes to invest, or already has invested, in the same vehicle in which the DAF is considering an investment. Are there circumstances in which the DAF investment may result in an impermissible benefit to the donor under Section 4967? Alternatively, could a co-investment situation result in a Section 4958 excess benefit to the donor advisor? The IRS has issued rulings describing co-investment situations involving a private foundation and a disqualified person that could result in self-dealing under Section 4941.³¹ It may be that co-investment situations involving a DAF and a donor advisor could raise similar concerns about the DAF investment improperly benefitting the donor advisor who also has a stake in the investment.

Securities and investment advisor laws. Federal and state securities laws regulate how securities may be offered and sold. The Investment Advisers Act of 1940 regulates persons offering advice or making recommendations on securities. A sponsor may need legal advice to ensure that its proposal for offering mission-related investment opportunities to donors or customers of its philanthropy services do not inadvertently fall under any of these laws.

State lending laws. Some states subject lenders to specific regulation.³² An exemption for program-related loans may be available. The sponsoring organization would need to review applicable law to see if its impact investment options trigger any additional reporting or registration requirements for lenders.

Addressing the risk of investment loss

Because sponsoring organizations make investments with their own money, the sponsoring organization must accept the risk of loss if an investment fails. Managers of the sponsor who are responsible for investment decisions must meet their fiduciary duties in vetting and selecting investments, and they may come under scrutiny from donors, regulators, and others for decisions that result in investment losses. To minimize these risks, the sponsoring organization should con-

sider adopting safeguards in the investment process. For instance:

- Consider investing general funds first instead of DAF money to establish a mission-related investment practice.
- Invest in intermediaries with a proven track record and expertise in making impact investments rather than directly investing in specific companies.
- Conduct extensive due diligence by individuals with the appropriate expertise, for instance through a committee established specifically for this purpose.
- Establish an investment policy ensuring that the sponsoring organization's investment portfolio must fall within established risk parameters.
- Create materials for donors that explain the investment program and risks involved. In addition, have donor advisors agree in writing that they understand the risks, including the fact that there is no guarantee of a return of principal and the possibility that funds in the account may be illiquid as a result of the investments and therefore not available for grantmaking.

Conclusion

When the Treasury Department and the IRS issue regulations interpreting the rules governing DAFs, it would be helpful to receive guidance as to how DAF investments will be treated for federal tax purposes. For instance, if some types of investment (e.g., a loan with no or a very low rate of interest) might be considered a distribution, a sponsoring organization may not be able to make the distribution to an individual and would need to conduct expenditure responsibility if the recipient is not a charity. The non-charity recipient also might be limited in what it can do with the funds as a result of expenditure responsibility requirements (e.g., no micro-loans to individuals).

If the IRS does not recognize any investment made through a DAF as akin to a charitable PRI, it may be more likely that these investments would be subject to applicable prudent investment rules. DAF sponsoring organizations are not private foundations and therefore do not need to meet the jeopardizing investment requirements under Section 4944. Nevertheless, state law fiduciary investment standards may still apply. Without IRS guidance indicating that certain DAF investments are deemed program-related for tax law purposes, it is unclear what standard might be applied to

qualify an investment as sufficiently program-related for state law purposes and therefore not subject to prudent investor rules.

In addition, state law UPMIFA involves additional uncertainty in considering whether to look only at the sponsoring organization as a whole or also at individual DAFs—in particular, DAFs that are managed independently by an investment advisor—in determining whether the fiduciary standard has been met. Under UPMIFA, if an individual DAF could be considered to meet the definition of an “institutional fund,” the sponsoring organization would apply the statutory investment standard to the individual fund. The individual fund therefore would need to be properly diversified and invested prudently. If, at the time of a donation, a donor expressly permitted or required the consideration of mission-related criteria in investing the donated funds, an investment properly based on these criteria should not be barred by the UPMIFA prudent investment standards. However, while there is an exception for following instructions in a donor’s gift instrument, an investment advisor’s representation may not qualify. The advisor is typically the sponsoring organization’s advisor, even if recommended by the donor.

If an investment will not meet applicable prudent investment standards, it is probably safest to make below-market loans to public charity recipients. Loans to public charities avoid the expenditure responsibility question and would be most likely to meet the program-related exceptions to state prudent investment standards. This option may include, for instance, loans to intermediary organizations structured as public charities that then loan or

otherwise invest the money through programmatic investments in other entities. In addition, applicable limits on the percentage of a business that a DAF can own may make it easier to make loans through DAFs rather than equity investments.

A concern specifically for DAFs is the possibility that a donor will become upset if his or her DAF suffers a significant investment loss. If the donor has not expressly authorized an investment or investment strategy, he or she could claim that the sponsor and its investment advisors should have vetted the investment option more thoroughly. While the donor may not have standing to claim harm (the DAF, after all, is no longer the donor’s money), the sponsoring organization might have some vulnerability if a donor complained to a state attorney general, who then might take a closer look at how the sponsoring organization invested charitable funds.

If a sponsoring organization can qualify a fund as something other than a DAF, the rules applicable specifically to DAFs described above would not apply to that fund. For instance, the Code definition of a DAF excludes a fund that benefits a single identified organization. “Field of interest funds” also fall outside the definition. A field of interest fund involves multiple donors that pool their funds and typically makes distributions restricted to a particular program area, such as education or the environment. Either option might be available under certain circumstances to avoid the current uncertainty around the DAF rules. Other issues, however, such as the state law prudent investment requirements for a separate fund, would remain ■