

Navigating IRS Rules for Donor-Advised Funds

A Comprehensive Guide for Nonprofit Executives, DAF Sponsors, and Compliance Officers

This presentation outlines critical IRS regulations governing Donor-Advised Funds, highlighting compliance requirements, potential pitfalls, and best practices for maintaining charitable integrity.



Agenda

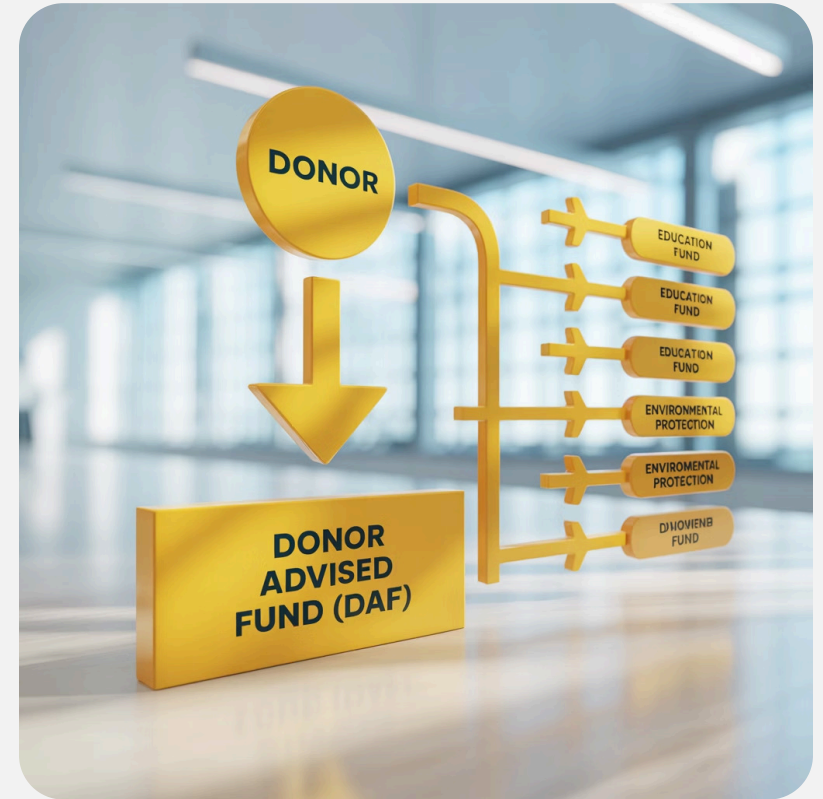
- 1 DAF Fundamentals & Legal Framework**
Understanding the core structure and IRS governance
- 2 Key Compliance Requirements**
Ten critical rules governing DAF operations
- 3 Potential Penalties & Consequences**
What's at stake with non-compliance
- 4 Best Practices & Implementation**
Practical steps for maintaining compliance
- 5 Case Studies & Takeaways**
Real-world examples and action items

What is a Donor-Advised Fund?

A Donor-Advised Fund (DAF) is a philanthropic vehicle established at a public charity that allows donors to:

- Make a charitable contribution
- Receive an immediate tax deduction
- Recommend grants from the fund over time

DAFs have grown exponentially over the past decade, with assets exceeding **\$160 billion** in 2022, making them a significant force in American philanthropy.



The Legal Framework

Pension Protection Act of 2006

First comprehensive legislation specifically addressing DAFs, establishing definitions and restrictions

Internal Revenue Code

Key sections include §170 (charitable deductions), §4966 (taxable distributions), and §4958 (excess benefit transactions)

Treasury Regulations

Detailed implementation guidance providing specific rules for DAF operations and compliance

IRS Revenue Rulings & Notices

Ongoing clarifications and interpretations of how tax laws apply to DAFs in specific situations

The 10 Critical IRS Rules for DAF Compliance

Understanding these requirements is essential for maintaining charitable integrity and avoiding penalties

Rule #2: No Private Benefit

Prohibited

- School tuition payments
- Membership fees with benefits
- Charitable auction items
- Gala/event tickets
- Goods or services received from donation

Permitted

- General support to qualified charities
- Program-specific support
- Capital campaign contributions
- Scholarships (if donor doesn't select recipients)
- Membership without significant benefits

Gray Areas

- Recognition (naming rights, plaques)
- Mission trips (case-by-case evaluation)
- Religious pilgrimages
- Token benefits below IRS thresholds
- Donor participation in charity events

The key question: Is the donor receiving something of more than incidental value in return for the grant?

Rule #3: No Fulfillment of Pledges

The Prohibition:

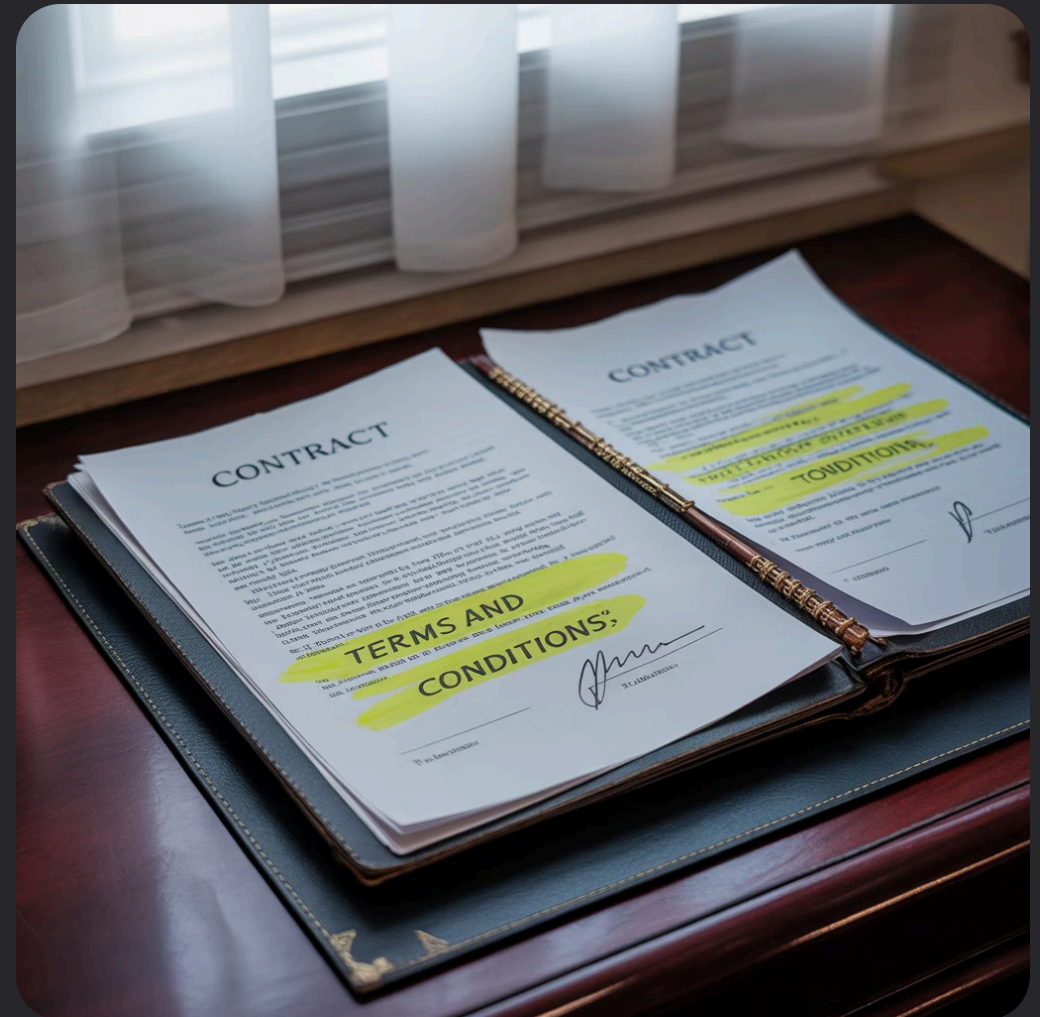
DAF grants cannot be used to fulfill legally binding pledges made by donors, advisors, or related parties.

Why This Matters:

When a donor makes a pledge, they create a personal legal obligation. Using a DAF to satisfy this obligation would constitute a private benefit, as it relieves the donor of a financial commitment.

⊗ Common Mistake

Many donors and even some charities don't understand this distinction, creating compliance risks when pledge cards or agreements are signed before DAF grants are recommended.



Rule #4: Prohibited Benefits



Event Tickets

Cannot use DAF grants to purchase tickets that provide the donor with admission to events, even if only a portion covers the benefit.



Charity Auctions

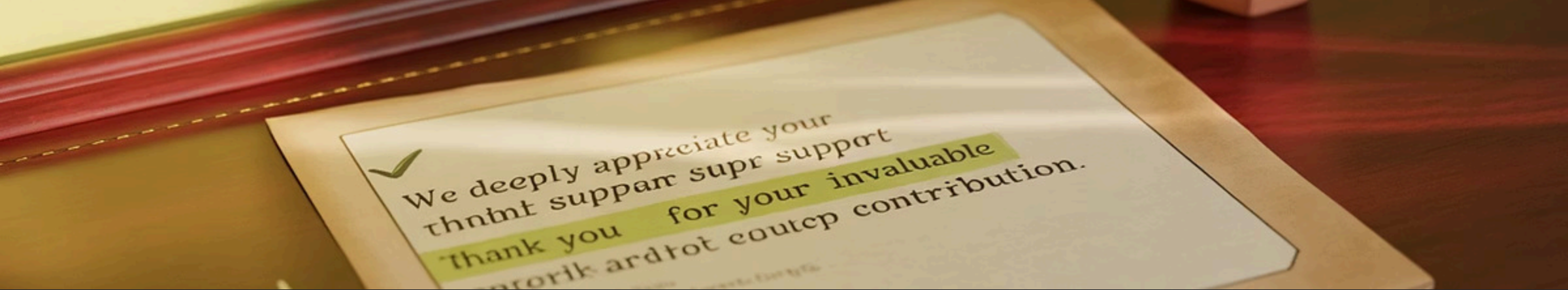
DAF grants cannot be used to bid on or purchase items at charitable auctions, as this provides tangible goods to the donor.



Membership Benefits

Grants cannot cover memberships that provide more than token benefits (discounts, free admission, etc.)

Consequences: Accepting prohibited benefits can trigger excise taxes on donors (125% of the benefit) AND on fund managers (10% of the amount, up to \$10,000 per transaction).



Rule #5: Grant Acknowledgement Requirements

When a charity receives a grant from a DAF, the acknowledgment must:

- Thank the sponsoring organization (not the individual donor)
- Acknowledge that the grant came from a specific DAF at the sponsoring organization
- Not state that the individual donor/advisor made the contribution
- Avoid language implying the grant fulfills a pledge

Best Practice

Sponsoring organizations should provide template acknowledgment language to grantees to ensure compliance with this requirement.

Rule #6: Excise Taxes on Taxable Distributions

IRC Section 4966

20%

Sponsor Tax

Initial tax on the sponsoring organization for making a taxable distribution

5%

Manager Tax

Tax on fund managers who knowingly approve taxable distributions (up to \$10,000 per distribution)

100%

Additional Tax

If not corrected within the taxable period, an additional 100% tax may apply to the sponsoring organization

50%

Manager Additional

Additional tax on fund managers for uncorrected distributions (up to \$20,000 per distribution)

A "taxable distribution" occurs when a DAF makes a distribution to an individual, non-qualifying organization, or for a non-charitable purpose.

Rule #7: Advisory Privilege vs. Control

The Legal Reality:

Donors may recommend (advise on) grants, but sponsoring organizations must maintain legal control over all distributions.

This distinction is fundamental to the DAF structure and its tax treatment.



Required Policies

Sponsoring organizations must maintain and enforce written policies that prevent donor control and retain ultimate discretion.

Due Diligence

Sponsors must conduct appropriate vetting of recommended grantees, regardless of donor preferences.

Documentation

Records must demonstrate independent review and approval of all grant recommendations.

Rule #8: Excess Benefit Transactions

IRC Section 4958



The Prohibition

DAF assets cannot be used to provide economic benefits to donors, advisors, or related parties beyond what's reasonable for services provided.



The Penalties

Disqualified persons who receive excess benefits face a 25% tax on the amount, plus 200% if not corrected promptly.



The Scrutiny

The IRS closely examines transactions between DAFs and their donors/advisors for potential violations.



Key Risk Areas: Compensation arrangements, business transactions, property sales/purchases, loans, and grant-making that indirectly benefits donors or their businesses.

Rule #9: Investment Rules

Prudent Investor Standards:

DAF assets must be managed according to prudent investor standards, with appropriate diversification and risk management.

Key Requirements:

- Investment policies must be formally documented
- Regular monitoring and performance evaluation
- Fees must be reasonable and transparent
- Jeopardizing investments should be avoided
- Conflict of interest policies must be enforced



Rule #10: Recordkeeping Requirements



Contribution Records

Detailed documentation of all donor contributions, including gift date, amount, and form (cash, securities, property).



Grant Documentation

Records of all grant recommendations, approvals, due diligence, and distributions, including correspondence.



Investment Activity

Comprehensive records of all investment decisions, transactions, and performance monitoring.



Tax Filings

Copies of all relevant tax filings, including Schedule D of Form 990 detailing DAF activity.

Records must be maintained for at least **7 years** to satisfy IRS requirements during potential audits.

Potential Penalties for Non-Compliance

The IRS has established significant penalties to ensure DAF compliance with charitable purpose requirements



Summary of Penalties

Violation Type	Penalty Amount	Applied To
Taxable Distributions	20% initial, 100% additional	Sponsoring organization
Manager Approval	5% initial, 50% additional (up to \$20,000)	Fund managers who knowingly approve violations
Prohibited Benefits	125% of benefit	Donors, advisors, or related parties who receive benefits
Manager Participation	10% (up to \$10,000 per transaction)	Fund managers who approve knowing benefit will result
Excess Benefit	25% initial, 200% additional if not corrected	Disqualified persons receiving excess benefits
False Statements	Potential criminal penalties	Anyone making materially false statements to the IRS

Beyond these financial penalties, reputational damage can be severe for both donors and sponsoring organizations.

Case Study: The College Admission Scandal

The Situation:

In 2019, the "Operation Varsity Blues" investigation revealed donors using DAFs to make payments to a sham charity that facilitated college admissions bribes.

The Violations:

- Private benefit (college admission for children)
- Non-charitable purpose (bribery)
- Grants to disqualified organizations disguised as legitimate charities

The Consequences:

Criminal charges, tax penalties, rescinded tax deductions, and severe reputational damage to all involved.



Best Practices for DAF Compliance

For Sponsoring Organizations

- Implement robust due diligence procedures for all grant recommendations
- Maintain clear documentation of independent decision-making
- Provide comprehensive donor education on prohibited uses
- Conduct regular compliance reviews and audits
- Train staff on recognizing red flags for improper recommendations

For Donors and Advisors

- Understand all DAF restrictions before establishing accounts
- Avoid making legally binding pledges that involve DAF grants
- Clearly separate personal and DAF philanthropy
- Document charitable intent for all contributions
- Consult tax advisors for complex situations

For Recipient Charities

- Properly acknowledge DAF grants (thank the sponsor, not just the advisor)
- Avoid linking DAF grants to event tickets or membership benefits
- Train development staff on DAF restrictions
- Develop DAF-specific solicitation materials
- Create policies for handling improper DAF grant requests

Key Takeaways

1 DAFs are heavily regulated philanthropic vehicles

The IRS has established clear rules to ensure charitable integrity and prevent abuse

2 Compliance is a shared responsibility

Sponsors, donors, and recipient organizations all have roles in maintaining compliance

3 Penalties for violations can be severe

Both financial penalties and reputational damage pose significant risks

4 Education is the best prevention

Understanding these rules helps all parties navigate the DAF landscape successfully



Questions?

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