

# What Grants Are Prohibited? Understanding DAF Rules, Advisory Privileges & IRS Penalties

Donor-Advised Funds (DAFs) offer powerful charitable giving vehicles, but come with strict IRS regulations. This presentation explores prohibited grants, the distinction between advisory privileges and control, and the penalties for non-compliance. Understanding these rules is essential for donors, advisors, and nonprofit organizations to maximize charitable impact while avoiding costly tax consequences.



# Chapter 1: Prohibited Grants in Donor-Advised Funds (DAFs)

Donor-Advised Funds have become increasingly popular philanthropic vehicles, but the IRS maintains strict guidelines on how these funds can be used. This chapter explores what types of grants are explicitly prohibited and why these restrictions exist.

## What is a DAF?

A donor-advised fund is a charitable giving vehicle sponsored by a public charity that allows donors to make a charitable contribution, receive an immediate tax deduction, and then recommend grants from the fund over time.

## Why Restrictions Matter

The IRS places restrictions on DAF grants to ensure they serve charitable purposes rather than providing personal benefits to donors, advisors, or their families.

# The IRS Prohibition: No Grants That Provide More Than Incidental Benefits

The IRS strictly prohibits DAF grants that provide "more than incidental benefits" to donors, advisors, or related parties. This broad rule forms the foundation of DAF grant restrictions.

The term "incidental" is critical - benefits that are tangential, minimal, or of insignificant value might be permissible, but anything substantive violates IRS regulations.

The prohibition applies to the donor, their family members, and other related parties as defined by IRS code.



## Examples of More Than Incidental Benefits:

- Tickets to charity galas or events
- Memberships with tangible benefits
- Auction items purchased with DAF funds
- Goods or services received in exchange for grants

# Common Prohibited Grant Uses



## Memberships

DAF grants cannot pay for dues or membership fees that provide more than incidental benefits, such as museum memberships with free admission or discounts.



## Event Tickets

Purchasing tickets or tables at charity events attended by donors or their families is prohibited, even if the donor only uses part of the ticket value.



## Controlled Scholarships

DAF grants cannot support scholarships where the donor controls or influences recipient selection, as this violates the arms-length requirement.



## Legal Pledges

Grants that satisfy legally binding pledges or personal obligations of the donor are prohibited as they constitute a personal benefit.

Understanding these prohibitions helps donors avoid inadvertent violations that could trigger tax penalties and compromise the charitable intent of their giving.

# Why These Restrictions Exist

## Upholding Tax Deduction Integrity

Donors receive immediate tax deductions when contributing to DAFs. The IRS ensures these deductions are justified by requiring funds to be used exclusively for charitable purposes without personal benefit.

## Preventing "Double Dipping"

Without these restrictions, donors could effectively receive both a tax deduction and personal benefits from the same funds—a form of "double dipping" that would undermine the tax code.

## Advancing Public Good

The fundamental purpose of charitable tax incentives is to encourage giving that benefits the public, not the donor. These restrictions help ensure DAF assets advance genuine charitable purposes.

## Consequences of Violations

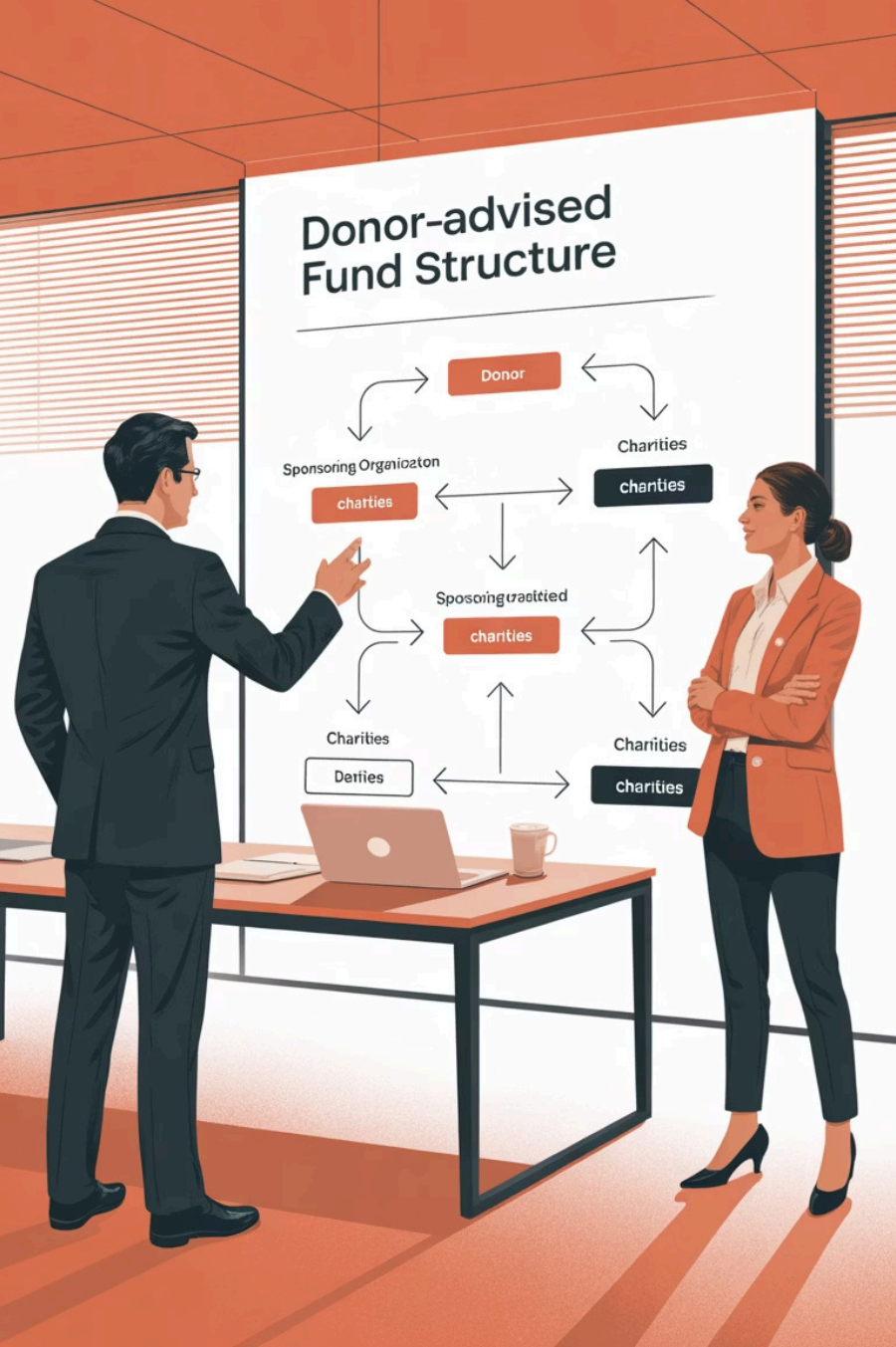
- Disallowance of tax deductions
- Excise taxes (up to 125% of the benefit)
- Potential penalties for both donors and sponsoring organizations

# DAFs Cannot Fund Benefits to Donors

The IRS prohibits using DAF grants to pay for charity event tickets, galas, or auction items that provide more than incidental benefits to donors, their families, or related parties.







## Chapter 2: Advisory Privileges vs. Control in DAF Giving

A critical distinction in DAF operations is understanding the difference between "advisory privileges" and "control." This distinction is fundamental to DAF compliance and affects everything from grant recommendations to investment strategies.

The balance between donor input and sponsoring organization authority defines the DAF relationship and helps maintain its charitable integrity.

# Legal Control vs. Advisory Privileges

## Sponsoring Organization Control

- Has legal ownership of all DAF assets
- Maintains exclusive legal control over all grants
- Can reject recommendations that violate policy
- Responsible for due diligence on all grants
- Bears legal liability for improper distributions

## Donor Advisory Privileges

- Can recommend (not direct) grants to qualified charities
- May suggest investment strategies for the fund
- Can name the fund and designate successor advisors
- Recommendations are non-binding
- Cannot demand specific actions or outcomes

This separation of roles is not merely semantic—it's a legal requirement that preserves the charitable nature of DAFs and their associated tax benefits.



# Why This Distinction Matters

## Maintaining Charitable Intent

Once assets enter a DAF, they must be irrevocably dedicated to charitable purposes. The advisory vs. control distinction ensures donors cannot reclaim assets or use them for personal purposes.

## Preserving Tax Benefits

The tax deduction received upon contribution is contingent on the sponsoring organization maintaining control. If donors retained control, contributions would be treated differently under tax law.



## Regulatory Compliance

Different regulatory frameworks apply based on who controls charitable assets. The DAF structure depends on the sponsoring organization maintaining ultimate authority over funds.

# Expanding Definition of Donor-Advisor

## Primary Donors

Individuals who make the initial contribution to establish the DAF account or make subsequent contributions.

## Family Members

Spouses, ancestors, children, grandchildren, great-grandchildren, and spouses of all descendants are considered related parties under IRS rules.

## Designated Advisors

Individuals appointed by the donor to have advisory privileges, including successor advisors who inherit advisory rights.

## Personal Investment Advisors

The Pension Protection Act expanded the definition to include investment advisors who manage the donor's personal assets, creating potential conflicts of interest if they also advise on DAF investments.

This expanded definition aims to prevent circumvention of rules through related parties and helps maintain the charitable integrity of DAFs.

# Real-World Impact

While the advisory vs. control distinction might seem technical, it has significant practical implications for DAF operations:

## Balancing Act

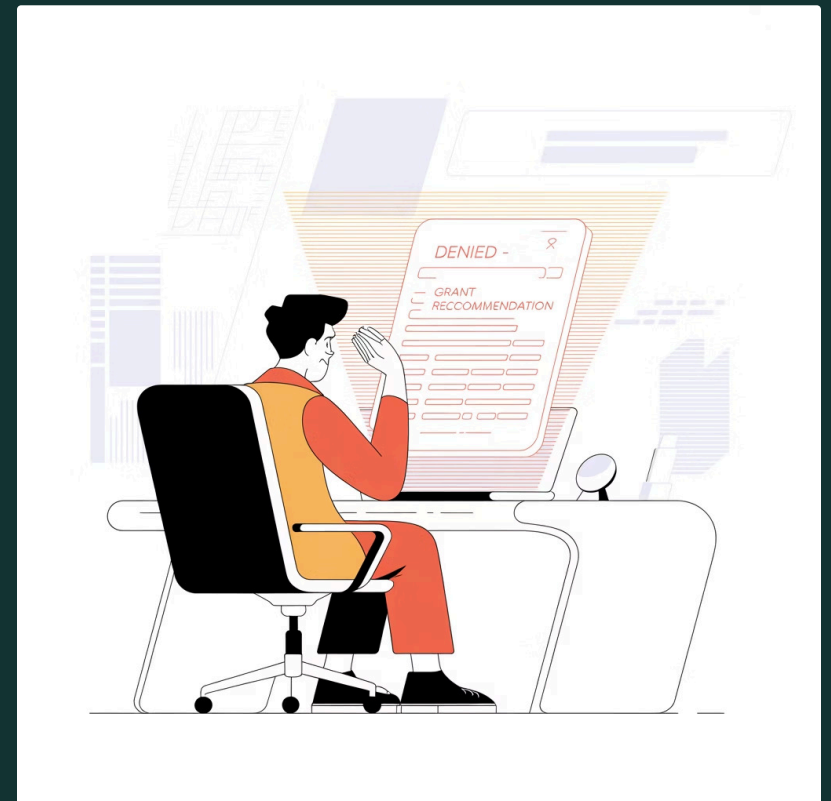
Most sponsoring organizations strive to honor donor recommendations whenever possible, creating a collaborative relationship that respects donor intent while maintaining legal compliance.

## Rejection Authority

Sponsoring organizations must—and do—reject grant recommendations that would violate IRS rules or their own policies, even when donors strongly advocate for them.

## Consequences of Overreach

- IRS penalties for both donors and sponsoring organizations
- Potential loss of tax-exempt status
- Disallowance of tax deductions
- Damage to reputation and credibility





## Chapter 3: Excise Taxes and Penalties: Avoiding IRS Traps

The IRS enforces DAF regulations through a system of excise taxes and penalties designed to discourage misuse and ensure compliance. Understanding these potential penalties is crucial for donors, advisors, and sponsoring organizations.

The excise tax provisions specifically targeting DAFs were introduced in the Pension Protection Act of 2006 and significantly increased the financial stakes for non-compliance.

# Key IRS Excise Taxes Affecting DAFs



## Section 4966: Taxable Distributions

Imposes a 20% excise tax on sponsoring organizations for distributions to non-qualifying recipients or for non-charitable purposes. An additional 5% tax may apply to fund managers who knowingly approve such distributions.



## Section 4958: Excess Benefit Transactions

Imposes a 25% excise tax on donors, advisors, or related parties who receive improper benefits from a DAF. An additional 200% tax applies if the benefit is not returned, and a 10% tax may apply to fund managers who approve the transaction.

These tax provisions have real financial consequences and serve as the IRS's primary enforcement mechanism for DAF regulations. The tiered structure creates escalating penalties for uncorrected violations.



# Examples of Taxable Distributions

## Non-Qualified Recipients

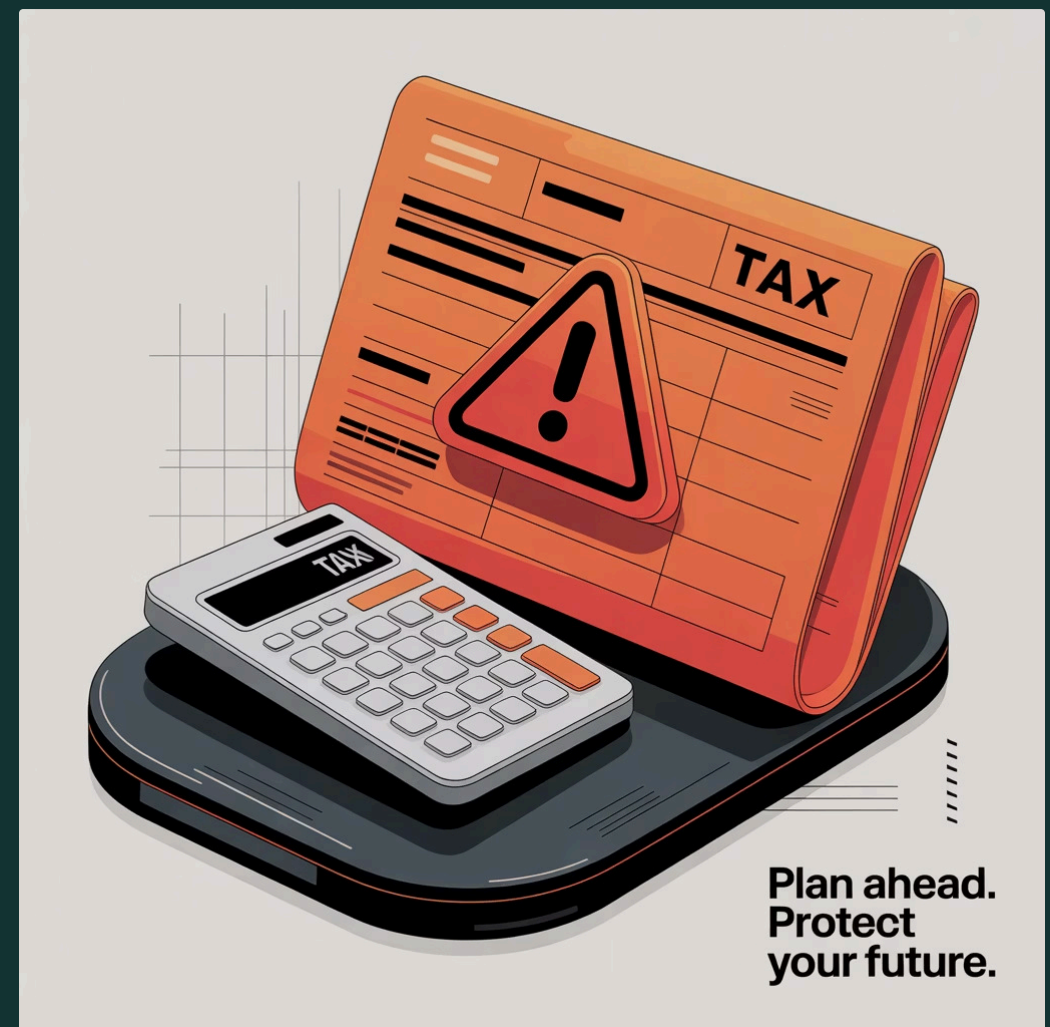
Grants to organizations other than qualifying public charities (501(c)(3)) can trigger excise taxes. This includes:

- Grants to private non-operating foundations
- Grants to most foreign organizations without equivalency determination
- Grants to 501(c)(4), 501(c)(6), or other non-charitable entities

## Prohibited Purposes

Even grants to qualified recipients can trigger taxes if they provide more than incidental benefits to disqualified persons:

- Grants paying for event tickets where donors attend
- Grants funding memberships with tangible benefits
- Grants satisfying legally binding pledges of donors
- Grants creating "donor-controlled" scholarships





# Excess Benefit Transactions Explained

## Direct Payments

DAF assets cannot be used to make direct payments to donors, advisors, or related parties, including salaries, fees, or reimbursements.

## Indirect Benefits

Even indirect benefits flowing from DAF grants to donors or related parties can trigger excess benefit transaction penalties.



## Investment Advisor Fees

The Pension Protection Act specifically prohibits DAFs from paying investment advisory fees to donors or related investment advisors, subject to a 25% excise tax.

## Business Transactions

DAFs cannot engage in business transactions with donors or related parties, including purchasing services or products from donor-owned businesses.

The IRS defines "excess benefit" broadly to include any financial benefit provided to a disqualified person that exceeds the value of consideration received by the DAF.

# IRS Enforcement Actions

## Disallowance of Deductions

The IRS can retroactively disallow charitable deductions claimed for DAF contributions if funds are later used in prohibited ways.

## Excise Tax Assessment

Multiple parties may face excise taxes:

- Donors/advisors: 25% initial tax on improper benefits
- Additional 200% tax if not corrected promptly
- Sponsoring organizations: 20% tax on taxable distributions
- Fund managers: 5-10% tax for knowing participation

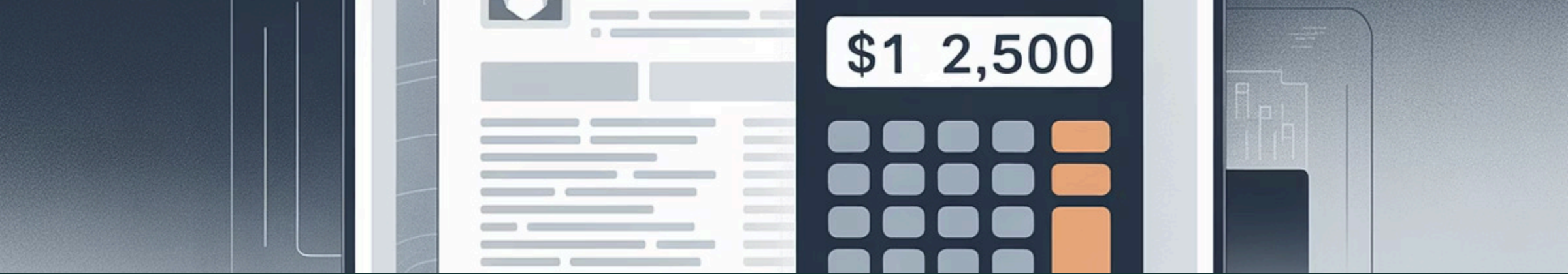
## Loss of Tax-Exempt Status

Sponsoring organizations that repeatedly allow prohibited transactions risk losing their 501(c)(3) status entirely.

## Public Disclosure

Excise tax assessments become part of public record through Form 4720 filings, potentially damaging reputations of both donors and sponsoring organizations.





## Penalties Can Be Severe and Costly

The combination of excise taxes, interest, potential loss of deductions, and reputational damage makes DAF compliance critical. Penalties can quickly escalate to exceed the original grant amount many times over.

# Best Practices to Avoid IRS Traps



## Verify Charitable Status

Ensure all grant recipients are qualified 501(c)(3) public charities. Use the IRS Tax Exempt Organization Search tool to verify current status before recommending grants.



## Review Benefits Carefully

Scrutinize potential grants for any personal benefits. If tickets, memberships, or other benefits are involved, pay for these separately with personal funds, not DAF assets.



## Consult Professionals

Work with tax advisors familiar with DAF regulations and maintain open communication with your sponsoring organization about any questionable grants.

When in doubt, the safest approach is to consult with both your sponsoring organization and your personal tax advisor before proceeding with any grant that might raise compliance questions.

# Summary: Navigating DAF Giving with Compliance and Impact

## Prohibited Grants

DAF grants cannot provide more than incidental benefits to donors or related parties, including:

- Event tickets and memberships with tangible benefits
- Fulfillment of legally binding pledges
- Donor-controlled scholarships or grants
- Any transaction providing personal benefit

## Advisory Role

Donors have advisory privileges but not control over DAF assets. Sponsoring organizations must maintain legal authority over all grant decisions.

## IRS Penalties

Non-compliance can trigger substantial excise taxes:

- Section 4966: 20% tax on improper distributions
- Section 4958: 25% tax on excess benefit transactions
- Additional taxes for uncorrected violations
- Potential loss of tax-exempt status for organizations

## Impact Focus

When used properly, DAFs provide tax-efficient vehicles for strategic philanthropy that advances genuine charitable purposes.

# Take Action: Use DAFs Wisely to Maximize Your Charitable Impact

## 1 Know Your Sponsoring Organization's Policies

Each DAF sponsor may have additional policies beyond IRS requirements. Familiarize yourself with their specific guidelines before recommending grants.

## 2 Document Grant Purposes

When recommending grants, clearly state the charitable purpose and explicitly note that you will not receive any benefits in return. This creates a paper trail of compliance.

## 3 Separate Personal and DAF Giving

For events or memberships, use personal funds—not DAF assets—to pay for any portion that provides personal benefits. Keep these transactions completely separate.

## 4 Focus on Impact

Remember the ultimate purpose of your DAF: to support causes you care about. By maintaining compliance, you protect both your tax benefits and your ability to make a meaningful difference through strategic philanthropy.

Contact your DAF sponsor or tax advisor with specific questions about compliance.