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IRS Rules Governing Donor-Advised Funds (DAFs)

Understanding IRC §§ 4966 & 4958

This comprehensive guide explores the Internal Revenue Service's regulatory framework for Donor-Advised Funds, focusing on the critical provisions that govern their operation, compliance requirements, and potential pitfalls. Whether you're a donor, fund manager, or nonprofit executive, understanding these complex rules is essential for maximizing philanthropic impact while avoiding costly penalties.

What is a Donor-Advised Fund (DAF)?

A Donor-Advised Fund represents a unique philanthropic vehicle that blends immediate tax benefits with long-term charitable giving power. These funds have grown exponentially in popularity over the past decade, with assets under management exceeding \$234 billion as of 2023.

Legal Structure

A DAF is a separately identified fund maintained by a 501(c)(3) sponsoring organization (typically a community foundation, financial institution, or single-issue charity).

Contribution Mechanics

Donors contribute cash, securities, or other assets to the fund and receive an immediate tax deduction for the full fair market value, subject to AGI limitations.

Control Dynamics

The sponsoring organization maintains legal control over all contributed assets, but donors retain advisory privileges regarding distributions and investments - creating a unique "influence without control" relationship that attracts IRS scrutiny.

Unlike private foundations, DAFs require no minimum distribution requirements (though this may change with pending legislation), have lower administrative costs, and offer greater privacy for donors who wish to remain anonymous in their giving.



Key Distinction

While donors can **advise** on distributions, the sponsoring organization makes the final legal determination on all grants. This distinction is fundamental to IRS compliance.

Why Regulate DAFs? IRS Concerns

The explosive growth of DAFs—from approximately \$14 billion in 2000 to over \$234 billion today—has triggered intensified IRS scrutiny. While most DAFs operate legitimately, the Service has identified concerning patterns of abuse that undermine charitable intent.

"DAFs present unique opportunities for tax avoidance when the connection between donor tax benefits and charitable use becomes attenuated."

— Treasury Department Report on DAF Regulation, 2023

The fundamental tension lies in the DAF's hybrid nature: donors receive immediate tax benefits while maintaining significant advisory influence over funds that, technically, they no longer own. This creates a regulatory gray area that some have exploited.

Documented Abuses

Tax-Sheltered Investment Income

Donors contribute appreciated assets to avoid capital gains taxes while effectively maintaining control over investment growth without distribution requirements.

Circular Transactions

DAF grants that ultimately benefit donors through tickets to charitable events, fulfillment of personal pledges, or payments to businesses owned by donor families.

Excessive Management Fees

DAF promoters charging inflated fees for managing donated assets while providing minimal charitable benefit to communities.

Valuation Manipulation

Donors claiming inflated tax deductions by manipulating the valuation of non-cash assets contributed to DAFs.

These abuses have triggered a comprehensive IRS response, including audits, regulatory updates, and targeted enforcement actions aimed at preserving the integrity of the charitable deduction system.

IRC § 4966: Excise Tax on Taxable Distributions

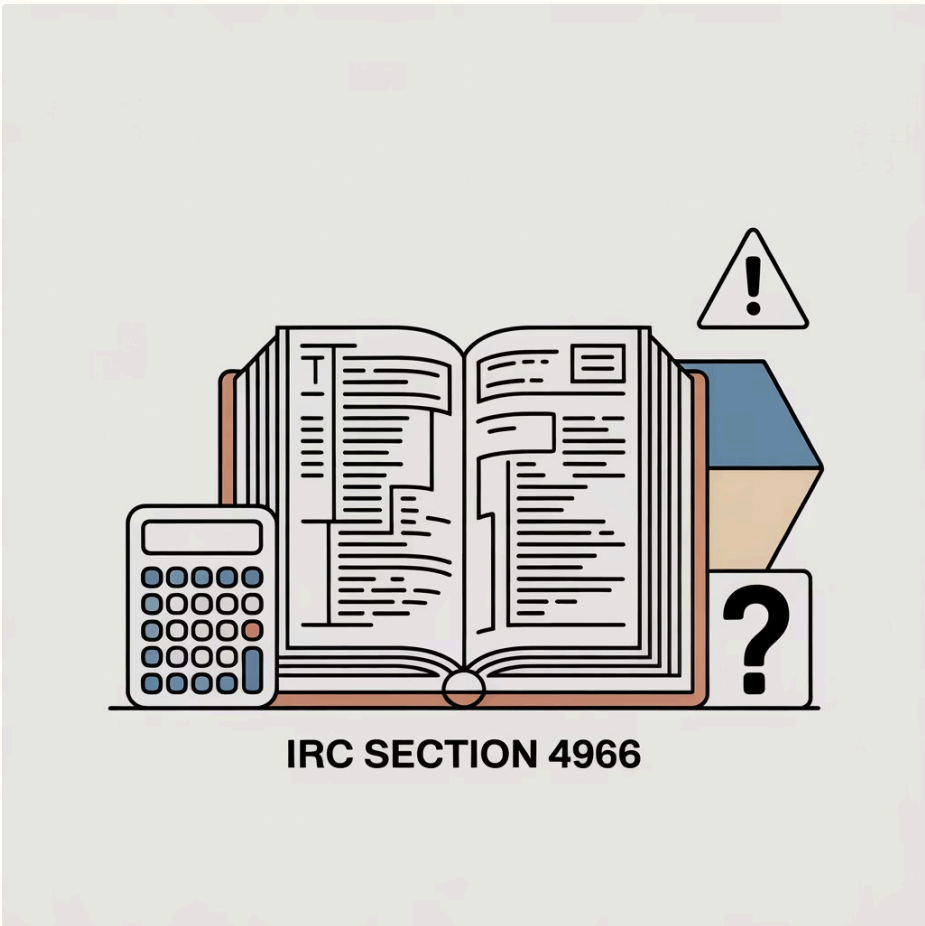
Section 4966, introduced as part of the Pension Protection Act of 2006, represents the IRS's primary enforcement mechanism specifically targeting DAF distribution practices. This provision imposes substantial penalties on both sponsoring organizations and fund managers who approve problematic grants.

Taxable Distribution Defined

Under § 4966, a "taxable distribution" is any distribution from a DAF that:

- Is made to an individual (regardless of purpose)
- Is made to a non-501(c)(3) organization (with limited exceptions)
- Is made to an organization where the donor, advisor, or related persons will receive more than "incidental benefits"
- Is made for any non-charitable purpose

This sweeping definition effectively limits DAF distributions to qualified 501(c)(3) public charities where no private benefit will result—significantly narrower than many donors realize.



Excise Tax Structure

Primary Tax	20% of the taxable distribution amount, imposed on the sponsoring organization
Additional Tax	5% of the taxable distribution (up to \$10,000 per distribution), imposed on any fund manager who knowingly approved the distribution
Burden of Proof	Sponsoring organization must demonstrate it exercised appropriate due diligence before making distributions



Critical Exception

§ 4966 provides an exception for grants to non-public charities if the sponsoring organization exercises "expenditure responsibility" - a rigorous oversight process requiring pre-grant inquiry, written agreements, segregated funds, detailed reporting, and remedial actions for misuse.

IRC § 4958: Excess Benefit Transactions

Fundamental Purpose

§ 4958 serves as the IRS's "anti-self-dealing" provision, imposing substantial excise taxes on transactions where "disqualified persons" receive economic benefits exceeding fair market value from tax-exempt organizations, including DAF sponsoring organizations.

Who Is "Disqualified"?

For DAFs specifically, "disqualified persons" include donors, donor advisors, members of their families, and entities they control. This broad definition captures not just direct donors but their extended network of influence.

Penalty Structure

The excise tax structure is deliberately punitive: 25% of the excess benefit amount imposed on the disqualified person, plus 10% (up to \$20,000) on organizational managers who knowingly approved the transaction. If not corrected promptly, an additional 200% tax applies.

Common DAF Transactions That Trigger § 4958



Prohibited Transaction

Example

Grants fulfilling personal pledges

DAF distribution used to satisfy donor's pre-existing legal obligation to a charity

Event ticket purchases

DAF pays for donor to attend charity gala, even if only the non-deductible portion

Business relationship benefits

DAF grant to organization that subsequently contracts with donor's business

Scholarship selection control

Donor maintains decision authority over recipients of DAF-funded scholarships

Personal expense payments

DAF funds travel, meals, or other expenses that benefit the donor or advisor

"The IRS has increasingly focused enforcement resources on identifying and addressing disguised private benefits flowing through donor-advised funds to their advisors and related parties."

— IRS Commissioner's Special Report on Tax-Exempt Organizations, 2023

The common thread across these examples is the diversion of charitable assets to provide economic benefits to those who established or advise the fund—precisely what § 4958 aims to prevent.

Key IRS Enforcement Examples

The IRS has significantly increased enforcement actions related to DAFs in recent years, with several high-profile cases establishing important compliance precedents. These enforcement examples demonstrate the Service's multi-faceted approach to DAF regulation beyond just excise taxes.

Deduction Disallowance

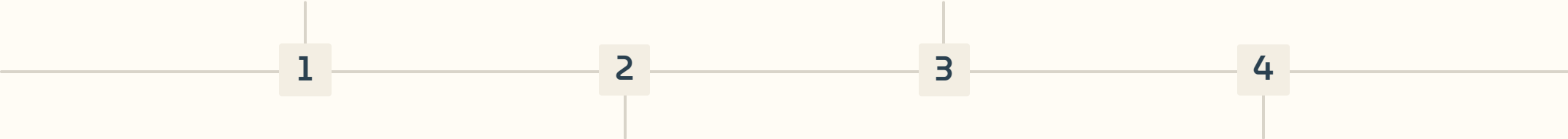
Case Study: In *Fairbairn v. Fidelity Investments Charitable Gift Fund* (N.D. Cal. 2021), the court upheld the IRS's position that donors who maintain effective control over DAF assets may lose their charitable deduction under IRC §170. The donors claimed Fidelity liquidated their donated stock too quickly, reducing the value—revealing their expectation of continued control over donated assets.

Enforcement Mechanism: Disallowing charitable deductions under IRC §170 for improper contributions to DAFs where donors retain too much control or expect specific benefits.

Self-Dealing Penalties

Case Study: In 2023, the IRS imposed \$4958 excise taxes exceeding \$1.2 million on a prominent donor advisor who directed DAF grants to a nonprofit that subsequently hired the advisor's consulting firm for "program evaluation services" at above-market rates.

Enforcement Mechanism: Applying \$4958 taxes on donors/managers for self-dealing or excess benefits received indirectly through DAF grants.



Excise Tax Application

Case Study: The IRS assessed \$4.8 million in \$4966 excise taxes against the Community Foundation of the Great Plains for allowing DAF distributions to fund donors' children's education expenses disguised as scholarships, without proper independent selection processes.

Enforcement Mechanism: Imposing \$4966 excise taxes on sponsoring organizations for impermissible grants that provide more than incidental benefits to donors or related parties.

Exempt Status Revocation

Case Study: The Tax Court upheld the IRS's revocation of 501(c)(3) status for the National Housing Foundation, which operated a DAF program that primarily benefited donors through elaborate circular transactions involving real estate.

Enforcement Mechanism: Revoking 501(c)(3) status for charities facilitating DAF abuses, the most severe enforcement option available.

These enforcement actions demonstrate the IRS's willingness to use its full regulatory arsenal against DAF abuses, with penalties potentially reaching millions of dollars and threatening the very existence of sponsoring organizations that fail to maintain proper oversight.

Recent IRS Proposals & Regulatory Changes (2024-2025)

The IRS and Treasury Department have signaled a significant regulatory shift regarding DAFs, with several proposals and guidance updates released in late 2023 and early 2024. These changes reflect the government's growing concerns about DAFs potentially delaying charitable distributions and facilitating tax avoidance.

Expanded Definition of DAFs

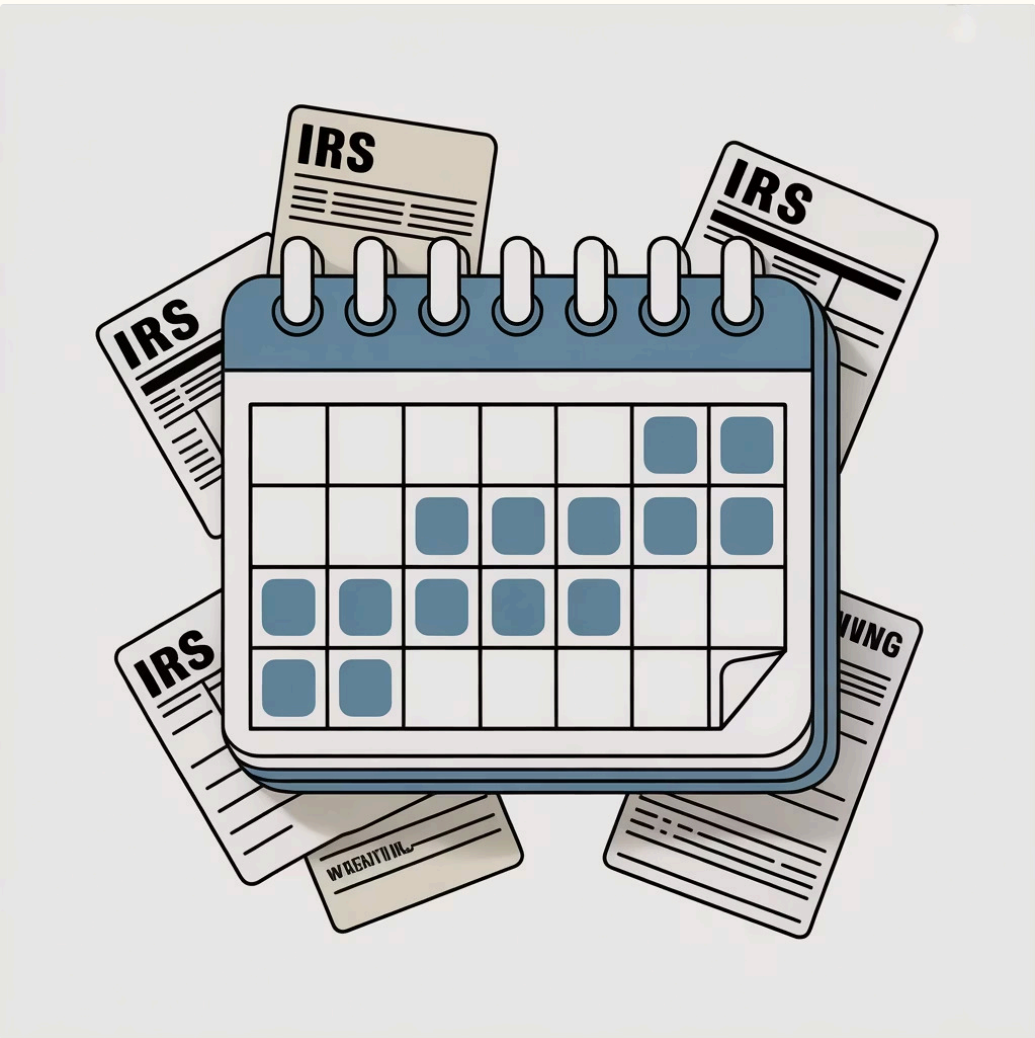
Proposed regulations now include "informal advisory control arrangements" within the definition of DAFs—capturing funds where donors lack formal advisory rights but maintain de facto influence through relationships with fund managers or institutional practices.

Deduction Timing Restrictions

The IRS has proposed that donors can only claim deductions when either:

1. The sponsoring organization makes qualifying distributions from the DAF, or
2. The donor irrevocably relinquishes all advisory privileges over the contributed assets

This represents a fundamental shift from current rules allowing immediate deductions upon contribution, regardless of when funds are distributed to working charities.



Private Benefit Crackdown

Pledge Fulfillment

New guidance explicitly prohibits DAF grants that fulfill personal pledges, even if the donor doesn't receive a formal acknowledgment. This reverses prior more permissive guidance from 2017.

Indirect Benefits

Expanded definition of "more than incidental benefits" to include reputation enhancement, business relationship development, and other non-monetary advantages.

Mandatory Distribution

Proposed 15-year maximum holding period for DAF assets, requiring complete distribution within this timeframe (with exceptions for community foundation DAFs).

⚠️ Implementation Timeline

The IRS has indicated these changes will be phased in between late 2024 and early 2026, with a grace period for sponsoring organizations to update policies and procedures. However, the Service has already begun applying some of these principles in audits and examinations.

Strategic Implications for Donors & Sponsors

For DAF Donors



Front-Load Contributions

Consider accelerating planned donations into DAFs before 2026 when new deduction floors are expected to take effect. This strategy allows securing current tax benefits while maintaining flexibility for future charitable recommendations.



Document Independence

Maintain clear separation between personal pledges and DAF grants. All communications with recipient organizations should emphasize the non-binding nature of potential DAF support and avoid any language suggesting personal obligation.



Review Grant Purposes

Scrutinize potential grants for any connections to personal or business interests that could trigger "more than incidental benefit" concerns. When in doubt, disclose potential conflicts to the sponsoring organization for review.

Most critically, donors should adjust their expectations regarding control. The IRS is increasingly enforcing the legal reality that DAF contributions represent completed gifts where donors retain influence but not control. Attempting to exercise excessive control may jeopardize both tax benefits and the sponsoring organization's compliance status.

For Sponsoring Organizations

Enhance Due Diligence

Implement robust pre-grant review processes that specifically screen for potential private benefit scenarios, including researching connections between donors and recipient organizations.

Update Grant Agreements

Revise grant agreements to include explicit prohibitions against providing benefits to donors and certification requirements for recipient organizations regarding how funds will be used.

Maintain Independence

Clearly document all instances where donor recommendations are declined or modified, establishing a pattern of independent judgment in grant-making decisions.

Educate Donors

Proactively communicate regulatory changes to donors, setting appropriate expectations about the limitations of advisory privileges and the organization's compliance obligations.

Sponsoring organizations face significant liability under both §4966 and §4958, with potential excise taxes that could threaten financial viability. The most prudent approach is establishing systems that prevent problematic grants before they occur, rather than defending them after the fact.

Visual Summary: DAF Compliance Landscape

The DAF Regulatory Framework

<p>Initial Contribution</p> <p>Donor makes irrevocable contribution to sponsoring organization and receives immediate tax deduction under IRC §170</p> <p>Risk Areas:</p> <ul style="list-style-type: none">• Donor expectations of control• Valuation of non-cash assets• Quid pro quo considerations	<p>Fund Management</p> <p>Sponsoring organization legally controls assets while donor maintains advisory privileges over investments and distributions</p> <p>Risk Areas:</p> <ul style="list-style-type: none">• Management fee structures• Investment advisor relationships• Demonstration of sponsor independence	<p>Grant Distribution</p> <p>Sponsoring organization makes grants based on donor advice but exercises independent judgment</p> <p>Risk Areas:</p> <ul style="list-style-type: none">• Private benefit to donors (§4958)• Taxable distributions (§4966)• Fulfillment of personal pledges• Grants to non-qualified organizations
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This visual representation highlights the three critical junctures where regulatory compliance issues typically arise in DAF operations. At each stage, both donors and sponsoring organizations have distinct responsibilities to maintain the charitable integrity of the arrangement. The IRS regulatory framework is designed to ensure that the substantial tax benefits provided for DAF contributions ultimately result in meaningful charitable impact rather than disguised private benefit.

Conclusion: Navigating the Complex IRS DAF Rules

The regulatory landscape for Donor-Advised Funds continues to evolve rapidly as the IRS refines its approach to ensuring these powerful philanthropic vehicles fulfill their intended charitable purpose.

Understanding the nuances of IRC §§ 4966 & 4958 is essential for both donors and sponsoring organizations seeking to maximize impact while maintaining compliance.

Key Takeaways

1 Protective Purpose

IRC §§ 4966 & 4958 serve as complementary safeguards protecting charitable integrity by preventing private benefit and self-dealing through DAFs. These provisions reflect Congress's determination that the substantial tax benefits of DAFs must be balanced with appropriate restrictions.

2 Heightened Enforcement

Recent IRS actions and proposals signal a new era of intensified scrutiny and narrower interpretations of permissible donor privileges. The days of viewing DAFs as entirely flexible giving vehicles with minimal restrictions are definitively over.

3 Strategic Adaptation

Both donors and sponsoring organizations must proactively adapt their strategies to ensure compliance while still accomplishing meaningful philanthropic goals. This requires both technical knowledge of the regulations and creative approaches to structuring charitable activities.



"The challenge is finding the balance between donor engagement and regulatory compliance—facilitating meaningful philanthropy while respecting the bright lines that protect the integrity of the charitable sector."

Next Steps

We recommend conducting a comprehensive review of your current DAF practices against the latest regulatory guidance. Our team can provide tailored recommendations to ensure your philanthropic strategy remains both impactful and compliant.