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ACCOUNTANTS AND ADVISORS

Private Foundations Bulletin

Donor-Advised Funds: A Guide for Private Foundation Leaders

Protecting Charitable Purpose and Managing Compliance While Meeting Payout Requirements

By Scott Brown, CPA, Partner, Jonathan Runfola, CPA, Director and Zein Alzein, Supervisor

Private foundations often want to expand their grant programs without adding administrative work. A donor-advised fund (DAF) can help a private foundation achieve this goal. A DAF is a separately identified charitable fund or account controlled by an eligible public charity known as the sponsoring organization. The sponsor can assess recipients, process grants, maintain account records and provide expertise that a smaller foundation may not have in-house.

A DAF may be useful in specific circumstances: when a foundation needs to meet its minimum distribution requirement at year-end or make a group of smaller grants. A DAF is also helpful when a foundation prefers that the sponsor, rather than the foundation, communicate with the recipient.

How DAF Contributions Count Toward the Distribution Requirement

Generally, private nonoperating foundations must make annual qualifying distributions based on 5% of the fair value of their noncharitable-use assets. Qualifying distributions include grants as well as necessary and reasonable administrative expenses paid toward further charitable goals.

Foundations must satisfy this requirement by the end of the following taxable year. Before making an additional distribution, the foundation should consider:

- Prior-year shortfalls
- Available excess qualifying distribution carryovers
- Rules governing how distributions are applied

A charitable contribution payment to an eligible DAF sponsoring organization may be treated as a qualifying distribution when it is made, even if the sponsor distributes grants from the account in a later year. The foundation should confirm the sponsor's public charity classification and consider any supporting-organization restrictions. It should also review relationships involving the foundation and individuals or entities considered disqualified persons under IRS rules. In this scenario, the sponsoring organization controls the contributed assets while the foundation retains only advisory privileges.

Potential Changes to Qualifying Distribution Rules

According to current federal tax law, there is no deadline by which a DAF must distribute the funds given by a foundation. The Biden administration's Treasury Greenbook for fiscal year 2025 proposed a different approach. Released in March 2024, this proposal has not been enacted but we believe that foundations should be aware of it. Under that proposal:

- The DAF would be required to make qualifying onward distributions by the end of the following taxable year (transfers to another DAF would be excluded from this requirement). Under the proposal, qualifying onward distributions would be payments from the DAF to eligible charitable recipients made by the end of the taxable year following the foundation's contribution to the DAF.

- The foundation would be required to maintain records or other evidence that the DAF's qualifying distributions were made within the required period.

Understanding Advisory Rights and Sponsor Control

Subject to the sponsor's agreement and policies, a foundation may make recommendations regarding the grant: its recipients, amount, timing, any restrictions or conditions and the investment approach for the account. The sponsoring organization retains authority to accept or reject those recommendations. Any recommended grant restrictions or conditions should be reviewed and approved by the sponsoring organization and, where appropriate, incorporated into the sponsor's agreement with the recipient. Making a separate agreement between the foundation and the recipient doesn't, by itself, bind the sponsoring organization or require payment from the DAF. Ordinary advisory rights alone generally don't give the foundation control over the sponsoring organization.

Managing Conflicts and Avoiding Prohibited Benefits

DAF grants shouldn't provide more than incidental benefits to foundation trustees, donors, advisors or related persons. Potential conflicts and benefits should be reviewed before a grant recommendation is submitted, as these arrangements may trigger excise taxes or private foundation self-dealing concerns.

Documenting DAF Contributions and Activity

A written DAF policy can help foundations manage these issues. At a minimum, policies should identify authorized advisors, approval thresholds, conflict-review procedures, record-retention responsibilities and frequency of board reporting.

The following practices can support the foundation's tax reporting and board oversight:

Before Funding the DAF

- Retain evidence of the sponsor's tax-exempt status.
- Review the DAF agreement, advisory provisions, fees and grantmaking policies.
- Document the charitable reason for using the DAF.
- Identify the authorized advisors.
- Address any relationships among the sponsor, intended grantees, advisors and foundation insiders.

After Funding the DAF

- Retain the board approval, contribution acknowledgment and payment record.
- Request periodic reports providing information about the grants.
- Perform annual grant reviews.

What Foundation Trustees Should Do Now

1. **Review the arrangement**. Confirm the sponsor's status, read the DAF agreement and identify any rights or relationships that warrant closer review.

2. **Confirm the reporting position.** Reconcile the contribution to the annual payout calculation and prepare the Form 990-PF disclosure support at the same time.

3. **Standardize the file**. Use the same core documentation for each DAF contribution, including the board rationale, payment support and activity reporting.

4. **Monitor developments.** Confirm legislation, final regulations and Form 990-PF instructions with the foundation's tax and legal advisors before relying on prior-year treatment.

A DAF is most effective when it serves a documented charitable purpose. It can be used as a tool to expand the foundation's administrative capabilities without obscuring the board's responsibility for the foundation's payout, tax reporting and grant oversight.

Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

Thomas F. Blaney, CPA, CFE
Partner
Co-Director of Foundation Services
tblaney@pkfod.com

Christopher D. Petermann, CPA
Partner
Co-Director of Foundation Services
cpetermann@pkfod.com

Joseph Ali, CPA
Partner
jali@pkfod.com

Elizabeth Gousse Ballotte
Partner
eballotte@pkfod.com

Scott Brown, CPA
Partner
sbrown@pkfod.com

Michael R. Koenecke, CPA
Partner
mkoenecke@pkfod.com

Anan Samara, EA
Partner
asamara@pkfod.com

This article was originally published on October 29, 2026.

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