


# DAF Reform—A Chance *to* Provide Real Benefit *to* Working Charities

by Dean Zerbe



**O**UR NATION'S CHARITIES PERFORM VITAL work—helping those in need, improving our communities, lifting up those suffering overseas. The public and policy-makers will support tax policies that they believe will get dollars into the hands of the charities actually doing the lift and pull. But there has been a growing cynicism from the perspectives of both the public and policy-makers that tax policies that are intended to encourage charitable donations and provide a meaningful difference in people's lives too often are not meeting expectations.

This is the real disconnect—the slip between cup and lip—that leaders in the charitable sector need to recognize. Every elected official is happy to give a speech extolling the importance of charities—similar to the first sentence of this article. The reality, though, is that policy-makers on both sides of the aisle have taken a hard eye to what

is really being accomplished by charities and to the effectiveness of tax policies for charities and charitable giving.

## Where We Are: The Charitable Sector and Washington, D.C.

The recent tax reform bill is Exhibit A for this reality. A number of major voices in the charitable sector decried the efforts of the Republicans in Congress to expand the standard deduction, which the Republicans viewed as a means of providing tax relief and simplification to working families.

In meetings with leading charities, I and others strongly encouraged them to recognize that opposing Republican leadership on the issue of increasing the standard deduction was a losing hand. We suggested that a better tack would be to look for common ground on policies that would encourage charitable giving, particularly giving that would put more dollars in the hands of those charities actually helping the poor, improving the community, and the like: the “working charities.” Reforms to donor-advised funds (DAFs) was put forward as a perfect example where reform could be realized that would provide significant meaningful benefit to working charities.

The charitable sector chose to fight. We all know the results: the tax reform bill doubled the standard deduction and expanded estate tax relief (viewed by some as harming charitable

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**DEAN ZERBE** is alliantgroup's national managing director. Prior to joining alliantgroup, Zerbe was senior counsel and tax counsel to the U.S. Senate Committee on Finance. During his tenure on the finance committee, Zerbe was involved in nearly every major piece of tax legislation signed into law—including the 2001 and 2003 tax reconciliation bills, the American Jobs Creation Act of 2004 (corporate tax reform), and the Pension Protection Act of 2006.

donations). Tax reform also included a number of other provisions that impacted charities: a new tax on university endowments; a new tax on high nonprofit salaries and benefits; UBIT (unrelated business income tax) expansion; limitations on donations vis-à-vis college athletics; bond reforms; and so on. The provisions encouraging charitable giving—Pease reform and an increase from 50 to 60 percent of adjusted gross income allowable as a deduction for cash donations made to public charities—are of some help, but perhaps more on the margins (and with Pease, were just a happy byproduct of a bigger reform goal).<sup>1</sup>

I fear that the Washington, D.C.-based charitable organizations are telling themselves (and the charities nationwide that they seek to represent) that the setbacks are just a partisan problem (ignoring that the previous Democratic administration had also proposed limiting charitable deductions—and there is hardly much in the way of successes in tax policy for charities to point to when Democrats ran the show). Alternatively, special pleading is put forth that the bad news is due to this staffer, that congressman, or a newspaper article. The charitable community needs to recognize that the old approach has failed—and that instead, it needs to engage and find common ground with, put forward positive solutions to, and champion best practices that will help working charities. It also needs to recognize that, for elected officials on both sides of the aisle, the door is wide open when it comes to constructive policy proposals from the working charities in their state or district: the corner soup kitchen, the local diaper bank, the clinic aiding communities stricken by abuse of opioids. If these organizations find their voices, they can be powerful in making DAF reform a reality.

### Where We Can Be: Charitable Reform to Help Working Charities

The above overview is intended to set the stage for suggested policy reforms for DAFs. While I think there is a need for reform in many parts of the tax code regarding charities and charitable giving (not just DAFs), DAFs are now a major (and growing) recipient of charitable donations and are a good place to start. And reform of DAFs is doable and

can have a major positive impact for working charities and the beneficiaries of these charities.

My comments here are broad and reflect my years of experience in Congress with charitable policy and DAFs, and what I believe are positive changes and reforms for the charitable community that can be accomplished. I have no dog in the fight except in seeing more charitable dollars get into the hands of working charities that are making a meaningful difference to the lives of millions of Americans.

### Payout: Money to Working Charities Today

Payout is the cornerstone of DAF reform. The whole rationale for the generous tax treatment of charitable deductions is that the money ends up in the hands of a charity that is actually helping those in need—providing the blankets, feeding the hungry—what I call “a working charity.” Having charitable donations go to banks (aka “warehouse charities”), with the wealthy getting their tax benefit today, the money managers getting their fees today, and the fiscal agent receiving fewer tax dollars today—while the poor see a benefit (maybe) tomorrow, or next year, or ten years from now—is nonsensical. We can do better.

The easy solution (also an anti-abuse measure) is to have a payout requirement for DAFs on an account-by-account basis. A starting point for discussion would be a payout from DAFs over five years (as proposed by former chair of the House Ways and Means Committee Rep. David Camp), or of 5 percent annually, similar to private foundations. But consideration should be given to a higher payout or to policies that encourage a higher payout (à la Camp). The argument that a floor for payout will become a ceiling doesn’t hold water. One look at the embarrassingly low payout of college endowments (that grow every year with additional donations), as well as the hundreds of DAFs that have no payout currently according to IRS Statistics of Income, shows what happens when there is no requirement of payout.

We cannot be blind to the fact that there is a real tension with DAFs. With humans being humans, managers of some DAFs—especially those managed by for-profit financial institutions (FIDAFs)—will feel in many cases a strong pull to

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keep funds under management. Policy-makers and supporters of working charities cannot ignore the reality that having more funds under management is the golden rule for money managers and financial institutions, and charities running DAFs aren't immune to this pull, either. Further, as shown in a number of studies, donors themselves often feel a strong pull to keep funds in a DAF and not pay out, for a variety of behavioral reasons.<sup>2</sup> The laws and regulations requiring payout—with incentives for getting dollars into the hands of the working charities—are necessary to counter that pull on both investors and donors to keep dollars in a DAF.

I encourage those who, in good faith, are concerned about the possible loss of donations to working charities from the increase of the standard deduction, to realize that at least a partial solution stretches before them—that being to encourage a greater proportion of the warehoused charity dollars at DAFs to go to working charities. Imagine if the energies and passion of the charitable community were focused on getting the billions of additional dollars out of warm banks and into the hands of working charities? The results would be astonishing.

### **Independence: DAFs That Put Working Charities First**

The IRS and Congress must recognize and address the pretense that is the linchpin of the largest DAFs—the DAFs that are essentially arms of financial institutions, the FIDAFs mentioned earlier. We are all familiar with these financial institutions (they are some of the biggest charities out there) that set up charities to receive donations from their clients/customers in DAFs and then continue to extract fees managing the money.

The reality of these FIDAFs is that they are commonly part of the mother financial institution. Typically located at the same place, and (mostly) sharing the same board members/officers, FIDAFs are essentially indistinguishable from—and, most important, have no independence from—the mother financial institution. The proof? Every year, the board of each of these FIDAFs scours the world to determine who is best placed to manage the funds of the FIDAF, and—surprise—it is the mother financial institution.

(I wonder what is the statistical probability that each FIDAF independently determines every year that its mother financial institution is the best one to manage the funds of the FIDAF.) Further, as discussed earlier, FIDAFs (as with all DAFs, but stronger with FIDAFs) have a strong pull toward keeping as many dollars under management as possible—which is counter to the policy of Congress and the public of getting dollars into the hands of working charities.

FIDAFs are playing by the current rules that they helped to write; we need to change those rules. For instance, a requirement that FIDAFs be operated and managed as independent charities—with the best interests of the charitable community in mind, and encouraging donors to make donations to working charities—would go far in cleaning up many of the problematic policies and practices regarding DAFs. A minimum starting point should be that the majority of the board members of these charities not be members of and have no relationship to the FIDAF, and that the independent board members be nominated and confirmed by independent board members.

And DAFs—especially DAFs managing billions of charitable dollars—must be housed at charities that enjoy broad public support, have independent boards, and are committed to the goal of getting dollars into the hands of working charities.

The results would be that some FIDAFs would adapt and carry on, but with a greater focus that puts working charities first. Over the long term, I would anticipate that we would see dollars moving to DAFs managed by community foundations, which would be able to provide better service to donors who have a focus on local charities.

### **End Estate and Tax Games—Cash and Tradeable Securities Only to DAFs**

While the reasons for payout on an individual account basis for DAFs are straightforward in terms of getting dollars into the hands of working charities, another reason for payout on an individual DAF account basis is that it serves as an anti-abuse measure. The hard reality is that some very wealthy individuals use DAFs as a means of abusive tax planning.

In the field of estate planning, you will see the



individual donate land, real estate, and shares in a closely held business (typically nonvoting) to a DAF (taking a significant charitable deduction, often with an optimistic fair-market value), and park the asset in the DAF. In short, the individual has reduced the overall value of the estate, benefited from the charitable deduction, and lost no substantive ownership interest.

On the tax planning side, there has been a huge increase in donations to DAFs of closely held stock, in-kind goods, and the like—all of which can allow the taxpayer to play fast and loose with inflated valuations.

These kinds of abusive transactions are difficult for the IRS to attack, with valuations always particularly difficult. It would be easier to limit charitable donations to DAFs to cash and tradeable securities (publicly traded stocks and bonds), similar to the limitations already in place for private foundations. Policy-makers should be aggressive in addressing the reality that DAFs are too often seen by tax planners as a work-around for the anti-abuse rules of private foundations.

Alternatively, policy-makers could look at requiring DAFs to sell the asset within a limited period of time or base its value with a set formula on the amount of income produced. Particularly intriguing is the idea that the donation would only be completed when the closely held stock, property, et cetera, is sold and the proceeds transferred to a working charity. This would end the valuation play and also get dollars into the hands of working charities. Washington, D.C., needs to provide a clearer message and guidance for DAF managers to say no to those who are making donations for their own interest and not in the interest of working charities.

### Charitable Dollars to Working Charities, Not to New Warehouses

In the wilderness of mirrors that is sometimes charitable policy, one of the oddest is that dollars warehoused in private foundations can be transferred to DAFs—and thus circumvent the payout requirements of private foundations. Is it too much to ask that at some point a donation for charity—for which the taxpayer received a significant tax benefit—actually ends up in the

hands of a charity that buys a blanket for a cold, homeless person? The simpler solution is to end this play and require that the private foundation distribute the dollars to a working charity or, alternatively, allow the transfer to a DAF with the requirement that the funds must be completely disbursed to working charities within a reasonable time period.

### Charitable Donations—Eventually to the Working Charity

The Roman Empire ended after a thousand years or so. Milk goes bad in days. Should there be an expiration date on an individual DAF account? Perhaps not an issue with a robust payout requirement, but the idea of requiring end periods for DAFs (having them expire after a set period with distribution to designated charities by the donor, or having them expire at the death of the donor, designated successor, etc.) should be addressed. Some charities that manage DAFs have some of these requirements, but it is a best practice that deserves adoption across the board. Again, it goes to the point that these dollars need to get into the hands of working charities as well as seek to honor donor intent, and that recognizing the countertension—that the money managers are happy to keep on managing and getting their fees ad infinitum—is key to reforming DAF practices.

### Improved Reporting

The IRS itself should take steps now to improve reporting on DAFs. The IRS Statistics of Income (especially the work of IRS senior statistician Paul Arnsberger) highlights the limited nature of data currently available on DAFs, especially individual DAF accounts. The IRS has extensive reporting requirements on the Form 990 Schedule A for supporting organizations—and the need for enhanced reporting on DAFs is arguably greater. The IRS should establish reporting requirements for large sponsors (over \$500 million) of DAFs and DAF accounts that will allow a heightened understanding of what is going on—on payout, acceptance/sale of nonpublicly traded property, and other issues of interest for public policy and compliance with the charitable laws. The enhanced reporting should also look at issues of

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board independence and management of funds, as well as provide an opportunity for the DAF sponsor to discuss the work it performs that provides substantive value to donors and working charities. Finally, DAF reporting should encourage best practices: addressing dormant/inactive funds, independent board members, control of investment decisions, and others identified by the charitable community.

## Best Practices for DAF Managers

Many charities that manage DAFs provide important and valuable support—especially those located at a number of community foundations. These charities that embrace managing DAFs and providing value to donors will highlight specific charities doing important work, foster donations, and encourage donors to move dollars into the hands of working charities—and also send out warnings of possible bad charities. The IRS should consider steps it could take to encourage more robust and engaged management of DAFs by charities through reporting and other requirements. Even more effective would be for the charitable community itself to establish best practices for DAF management and to highlight and champion those charities that are the best at managing DAFs. Similarly, organizations that are watchdogs, such as CharityWatch and BBB Wise Giving, should consider focusing some attention on this underserved part of the charitable community that holds billions and billions of dollars and is often the biggest recipient of charitable donations.

## Next Steps

I have no doubts, from my years working in Congress and seeing successful legislative efforts, that if the food banks, the homeless shelters, and the hosts of wonderful working charities tell Congress that DAF reform is a change that is needed and will make a real difference to their vital work, it will be quickly passed, with cooperation on both sides of the aisle. It would be enormously helpful to this effort if the private foundations, and especially the community foundations (who would also benefit from reform to DAFs), also pulled oars. The private foundations could

change the discussion overnight by funding and supporting efforts to bring forward DAF reforms (as some have, already making a big change in the discussion) and support charity watchdogs in this field.

For those who disagree with DAF reform or have other priorities for encouraging charitable donations to working charities, a note of caution: proposals that cost the sun and the moon are simply unrealistic and not workable. One of the great benefits of DAF reform is that we can see significantly more dollars moving to working charities at very low cost to the public fisc. The score of a proposal by the Joint Committee on Taxation is everything in terms of realizing success in this political environment. A low score in terms of revenue lost to the public fisc (which is the case with DAF reform) translates into a high possibility of getting changes signed into law. I appreciate that people are captivated by high-flying proposals for credits, et cetera, to encourage charitable giving. Unfortunately, they will cost the sun and the moon—and will not pass. Working charities need real help that DAF reform can provide—not pie in the sky.

DAF reform would mean that dollars that are donated for charitable purpose—and receive huge subsidies from the public and are currently warehoused on and on and on—would provide the real, tangible benefit of billions of additional dollars going *today* to the working charities across this country.

## NOTES

1. I recognize that supporters of tax reform highlight the hoped-for economic growth that will translate into jobs, improved communities, greater charitable giving. My point is that, on its own terms, the tax reform bill did not embrace the priorities of many Washington, D.C.-based charitable organizations.
2. See, for example, James Andreoni, “Warm Glow and Donor-Advised Funds: Insights from Behavioral Economics” (Working Paper presented at the Forum on Philanthropy and the Public Good, Washington, DC, October 23, 2015; revised May 2016).

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