

# Three Simple Steps to Protect Charities and American Taxpayers from the Rise of Donor-Advised Funds

by Ray D. Madoff

**W**ITHOUT A DOUBT, THE MOST NOTEWORTHY story affecting the charitable sector over the past twenty-five years has been the meteoric rise of donor-advised funds (DAFs). Within the blink of an eye, DAFs have grown from obscurity to ubiquity—and with the 2017 tax law<sup>1</sup> making *bunching* the new word in charitable giving, the growth of DAFs is expected to continue unabated.

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Consider the following:

- In 1992, the top ten fundraising charities were all well known to the public and included such familiar names as the American Red Cross, the American Cancer Society, and Catholic Charities USA. In 2017, none of the above charities were on the list, and six of the top ten were DAF sponsors and were unknown to most Americans (and sounding more like commercial financial institutions than traditional charities).<sup>2</sup>
- While contributions to charities as a whole have grown at a slow and steady pace, the rate of growth in DAF contributions has been astronomical. Since 2011, overall annual charitable giving has grown from \$300 billion (in 2011) to \$410 billion in 2017<sup>3</sup> (total growth of 36.6 percent).<sup>4</sup> Over that same time period, annual contributions to Fidelity Charitable, the largest DAF sponsor, have grown from \$1.7 billion in 2011<sup>5</sup> to \$6.8 billion in 2017 (total growth of over 400 percent).<sup>6</sup>
- DAFs are not only being funded by individuals. Many private foundations make significant distributions to DAFs. Private foundations can use DAFs to satisfy their 5 percent distribution requirements while still retaining ongoing control over the distributed property. In addition, DAFs allow private foundations to meet their disclosure requirement (by reporting their distribution to the DAF sponsor) while maintaining secrecy about the ultimate recipient of their distribution.

Why have DAFs moved to such a dominant position in the charitable landscape? There are three main reasons for their extraordinary growth:

1. DAFs enable donors to obtain current tax benefits of charitable giving while maintaining functional control over the investment and distribution of the donated property, without incurring the administrative expense and disclosure obligations imposed on private foundations.
2. DAFs enable donors to obtain maximum tax benefits for their contributions by facilitating the donation of appreciated property.

The donation of appreciated property provides a double tax benefit for donors, because it enables donors to both avoid capital gains taxes on donated property and offset their income tax liability based on the fair market value of the contributed property.<sup>7</sup> These benefits are particularly valuable as applied to donations of complex assets—property other than publicly traded stock—because these assets only provide very limited tax benefits when contributed to private foundations.<sup>8</sup>

3. DAF sponsors earn fees for the management of DAF funds. Ever since financial services companies have begun creating DAF sponsors, they have used their considerable marketing skills to fuel their growth. In addition, because individual financial advisors are also able to profit from managing DAF funds, their influence has assisted the growth of DAFs, as well. This increased public awareness of DAFs has fueled the growth of all DAF contributions, not just those associated with the financial services industry.

### Three Steps to Ensure That DAFs Work for Everyone

DAF sponsors and their representatives take the position that DAFs have been an unmitigated good for the charitable sector—democratizing philanthropy by making it easy for small donors to create their own perpetual endowments, and opening new sources of charitable giving by facilitating donations of complex assets (referred to by some as “philanthropic fracking”). However, by focusing on the interests of donors, these arguments fail to recognize that two critical interests have been ignored in the existing regulatory approach to DAFs: (1) charities and the beneficiaries they serve, and (2) American taxpayers.

The following three rules would address these interests by ensuring that charities get the necessary funds to do their work, and that the government doesn’t provide tax benefits that are incommensurate with public benefit, thereby burdening American taxpayers.

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### **Rule #1: Save Charities by Ensuring or Encouraging the Flow of Dollars from DAFs to Charities**

Tax benefits for charitable giving were granted in order to increase the flow of dollars to organizations engaged in charitable work. DAFs undermine fulfillment of this purpose by allowing donors to get all of the tax benefits of charitable giving at the time that the donation is made to the DAF, without providing any mechanism (or even encouragement) to ensure that any of the tax-benefited dollars are ever made available for charitable use. Because current law does not require payouts from DAFs, donors can indefinitely defer charitable distributions from their DAF accounts, even across multiple generations. While some individuals distribute their DAF accounts entirely within a single year, others make no distributions at all. According to an IRS study, while some DAF sponsors have high overall distribution rates, nearly 22 percent of the DAF sponsors in 2012 made zero distributions.<sup>9</sup> Even for those DAF sponsors with higher payouts, the reported rates can be misleading because they include distributions to other donor-advised funds, which can be substantial.<sup>10</sup>

There are many reasons why well-meaning donors may fail to make significant distributions from their DAFs, including the following:

1. Charitable decisions are difficult to make, and many donors have busy lives and therefore want to defer decision making. This common desire to defer decision making until absolutely necessary is evidenced by the number of charitable gifts that occur in the final days of the calendar year. By allowing donors to get the full tax benefits of giving without requiring outright (i.e., non-DAF) transfers of charitable assets, donors may never feel the need to disconnect from their DAF accounts.
2. Insofar as donors have a sense of ownership over DAF funds, behavioral economists suggest that the endowment effect may give donors a sense of loss when DAF accounts go down due to the distribution of DAF funds. The ability of donors to make

financial management decisions about DAF assets may increase the feeling that DAF accounts belong to donors, thereby increasing the endowment effect.

3. The fact that DAF sponsors and financial advisors benefit financially when assets remain in the DAF may cause them to subtly encourage donors to think of DAFs as accounts to hold rather than as funds to disburse. One way that sponsors and financial advisors may do this is to encourage donors to think of DAF funds as a charitable legacy to be passed on to younger generations.

In order to counter these tendencies, Congress should adopt rules that either incentivize distributions from DAFs or require DAFs to be distributed within a reasonable period of time from contribution.

**Incentivize distributions.** Congress could incentivize distributions from DAFs by tying some of the charitable tax benefits to the release of DAF funds. For example, Congress could enact rules that would allow donors to avoid capital gains on transfers of property into DAFs, but would delay the charitable deduction until such time as funds are distributed from the DAF to non-DAF beneficiaries.

**Set a Time Period for Payout.** Alternatively, Congress could impose a maximum time period for DAF accounts to be distributed outright to charities. This could easily be accomplished by requiring donors, as a condition of the deduction, to name a non-DAF charity that would receive any undistributed funds at the end of the designated period.<sup>11</sup> For example, if Congress were to impose a maximum time period of ten years, then a donor who funds a DAF in 2018 would be required to name a charity that would receive any remaining funds in the 2018 DAF account by 2028.<sup>12</sup> DAFs would maintain their flexibility, because donors could change their charitable designations by simply making distributions from that account before the termination date. A maximum distribution period would not undermine the effectiveness of DAFs or their appeal to donors. It would simply establish a limit that

would ensure that tax-benefited dollars are granted outright to nonprofits within a reasonable period of time.

### **Rule #2: Save Charities by Preventing DAFs from Being Used to Undermine Private Foundation Payout Rules**

In 1969, Congress became concerned that private foundations were providing too many tax benefits to donors without any assurances that donated funds would benefit the public in a timely manner. In order to address this concern, Congress enacted a rule that required private foundations to distribute roughly 5 percent of their assets each year to public charities.<sup>13</sup> Sensibly, the payout rule could not be evaded by a private foundation making distributions to other private foundations, because then the funds would simply await further distribution by that foundation.

Since the rise of donor-advised funds, some private foundations have been meeting their payout requirements by making grants to DAFs.<sup>14</sup> The foundation can then advise distribution of the grant from the DAF to a charity at a later date. This can have multiple benefits for the foundation: one is that the transfer counts for purposes of the foundation's payout (because the DAF sponsor is a public charity); another is that the foundation can disguise the source of the funding by flowing the funds through a DAF.

Neither of these benefits is consistent with the spirit of the rules that have governed private foundation conduct since the enactment of the Tax Reform Act of 1969. The payout is intended to measure distributions to active charities, not to other investment funds. Further, because of the potential for abuse at foundations, they are held to higher standards of transparency. Allowing foundation-to-DAF transfers to count for payout purposes is inconsistent with the policies behind the private foundation payout and disclosure rules.

In order to address these concerns, Congress should provide that foundation-to-DAF transfers are not "qualifying distributions" for purposes of a private foundation's payout.

### **Rule #3: Save American Taxpayers by Ensuring that Donors' Tax Benefits Are Commensurate with the Public Benefit of the Donation**

One of the reasons for the popularity of DAFs is their ability to give donors maximum tax benefits—indeed, the same benefits afforded outright donations to public charities—and ongoing control over donated property. Tax benefits for DAFs are particularly valuable with respect to donations of assets other than publicly traded stock. As a result, much of the growth of DAFs is attributable to these types of donations.

However, missing from the conversation regarding DAFs is how these donations may impose significantly greater costs—in terms of foregone tax revenue—than the public receives in terms of charitable benefits. This loss of revenue burdens all American taxpayers, who must pick up the slack.

The starting point is that donors get significantly more tax benefits by making contributions of appreciated property rather than cash to a charity. Where a contribution of cash can save the donor as much as \$0.37 on each dollar donated, a contribution of appreciated property can save the donor as much as \$0.57 for each dollar donated (taking into account both capital gains tax savings and income tax savings). Although donors can get this double tax benefit for contributions of publicly traded stock while still maintaining some control over donated property (by transferring the donation to a private foundation), if the property is not publicly traded stock, the donor's options are far more limited. In order to obtain the full double tax benefit for the contribution of property other than publicly traded stock (like real estate or closely held business interests), the donor must either make an outright donation to a public charity or must make a donation to a donor-advised fund. Since it is a natural human tendency to want to maintain rather than relinquish control, many donors choose DAFs.

As a result, a significant source of DAF assets is complex assets. The problem is that due to a variety of factors, it is quite likely that the tax benefits afforded to contributions of complex assets can outstrip the value to the public of

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these contributions. The reason for this is that complex assets, by definition, are difficult to value and lack a ready market for their sale, often resulting in significant transaction costs when converting these properties to cash. Each of these poses problems from a tax policy point of view.

Complex assets have no easily identified market value. As such, taxing authorities must depend on donors' hired appraisers to determine the property's fair market value. Valuation is an art rather than a science, and there is often a considerable range of defensible valuations for property that does not have a ready market. Being dependent on donors for their fees, there is a natural pressure on appraisers to come up with higher values that will afford donors better tax savings. Due to the expense and difficulty of valuing property that has no ready market value, it is virtually impossible for the IRS to provide sufficient oversight for the amount of complex assets contributed to donor-advised funds.<sup>15</sup>

More troubling is the fact that the appraised value of property does not include the cost of converting that property to cash. What this means is that a donor's deduction is likely to be greater than the amount that ends up being available for distribution. Depending on the time that it takes to sell the property and the expenses associated with the sale, there can be a significant disconnect between these two numbers.

Consider the case of a donor that has a condominium in an area where the market is currently depressed. Assume the condominium has an appraised value of \$500,000. After donation, the DAF sponsor may have to pay significant fees associated with the property (such as property taxes, utilities, and condominium fees), and the eventual sale of the property will require payment of transfer taxes and real estate brokerage fees. After all of these expenses are paid, only \$400,000 is allocated to the donor's DAF, even though the donor was allowed to take a tax deduction based on a \$500,000 appraised value.<sup>16</sup>

In order to ensure that the tax benefits afforded donations are commensurate with the value provided to the public, the charitable

tax deduction for donations of complex assets should not be based on appraised value but instead should be based on the net value ultimately transferred to the donor's DAF account. This could be accomplished either by requiring the donor to wait to take the deduction until the property is sold or by providing for the recapture of tax benefits to the extent that the claimed deduction exceeded the value of the contribution.

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Donor-advised funds are here to stay—in large part due to the enormous benefits they afford to donors, DAF sponsors, and the financial services industry. By enacting appropriate regulation that takes into account the interests of charities and American taxpayers, we can ensure that DAFs act as seeds of growth to the charitable sector—and not seeds of destruction.

#### NOTES

1. Officially called "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."
2. Peter Olsen-Phillips and Brian O' Leary, "How much America's Biggest Charities Raise: 27 Years of Data," *The Chronicle of Philanthropy*, October 31, 2017, [www.philanthropy.com/interactives/philanthropy-400?cid=cpw\\_featuredata#id=table\\_1992](http://www.philanthropy.com/interactives/philanthropy-400?cid=cpw_featuredata#id=table_1992) and [www.philanthropy.com/interactives/philanthropy-400?cid=cpw\\_featuredata#id=table\\_2017](http://www.philanthropy.com/interactives/philanthropy-400?cid=cpw_featuredata#id=table_2017).
3. *Giving USA 2018: The Annual Report on Philanthropy for the Year 2017* (Chicago: Giving USA, 2018).
4. "Charitable Giving Rose 4 Percent in 2011, 'Giving USA' Finds," *Philanthropy News Digest*, June 20, 2012, [www.philanthropynewsdigest.org/news/charitable-giving-rose-4-percent-in-2011-giving-usa-finds](http://www.philanthropynewsdigest.org/news/charitable-giving-rose-4-percent-in-2011-giving-usa-finds).
5. *2012 Annual Report: Reporting on Fiscal Year Ending June 30, 2012* (Covington, KY: Fidelity Charitable, 2012).
6. *2017 Annual Report* (Covington, KY: Fidelity Charitable, 2017), 25.
7. The effect of this double benefit is significant. A donor making a contribution of cash can receive tax

benefits of thirty-seven cents for each dollar contributed, whereas a donor making a contribution of appreciated property can receive tax benefits of up to fifty-seven cents for each dollar contributed. The reason for this discrepancy is because the donor can avoid capital gains taxes on the appreciation of the property (which would otherwise be taxed up to 20 percent) and can also offset ordinary income, which would otherwise be taxed at up to 37 percent.

8. A donor's charitable deduction for the contribution of complex assets to a private foundation is not based on the property's fair market value but instead is limited to the property's basis (the amount the donor paid for the investment). Closely held businesses—particularly those that are based on technology—often have very low tax bases.

9. Paul Arnsberger, "Donor-Advised Funds: An Overview Using IRS Data" (paper presented at the conference "The Rise of Donor Advised Funds: Should Congress Respond?," Forum on Philanthropy and the Public Good, Washington, DC, October 23, 2015; revised November 20, 2016).

10. According to a recent article in *The Economist*, Fidelity Charitable was the top recipient of distributions from three of the largest commercially affiliated DAF sponsors—Fidelity, Schwab, and Vanguard. In addition, the third largest recipient was the American Endowment Foundation, another DAF sponsor. See "A philanthropic boom: 'donor-advised funds': The rise of DAFs may be as much about tax as charity," *The Economist* (March 23, 2017), [www.economist.com/news/finance-and-economics/21719494-rise-dafs-may-be-much-about-tax-charity-philanthropic-boom](http://www.economist.com/news/finance-and-economics/21719494-rise-dafs-may-be-much-about-tax-charity-philanthropic-boom).

11. A term limit is preferable to the annual 5 percent payout model applicable to private foundations. An annual payout rule would remove the flexibility of donor-advised funds without significantly increasing the flow of dollars to nonprofits. Experience with private foundations suggests that donors are susceptible to treating floors as ceilings; therefore, they may be more likely to think of their DAFs as perpetual accounts. In addition, since DAFs are sponsored by public charities, donors receive significantly greater tax advantages for their contributions to DAFs. As a result, it makes sense for DAFs to be subject to stricter payout terms that ensure

that all DAF dollars are eventually made available for use by charities.

12. Multiple contributions could simply be grouped by year, so that all 2018 contributions would be allocated to the 2018 fund (with an outside distribution date of 2028), and 2019 contributions would be allocated to the 2019 fund (with an outside distribution date of 2029).

13. Qualifying distributions also include funds spent directly for charitable purposes.

14. *The Economist* found that some private foundations distribute 90 percent of their qualifying distributions to DAFs. See "A philanthropic boom: 'donor-advised funds'."

15. This has led some to question whether we should be allowing deductions for charitable contributions of property. See Roger Colinvaux, "Charitable Contributions of Property: A Broken System Reimagined," *Harvard Journal on Legislation* 50, no. 2 (June 2013): 263–329.

16. And theoretically, the reverse can happen. The charitable deduction is based on the value of the property at the time of transfer to the DAF and not at the time that the property is ultimately sold. Thus, a property could acquire higher value so that a higher amount than the original appraised value gets allocated to the donor's DAF, while the donor's tax break stays as it was originally. It is also possible that an appraiser could underestimate the value of the contributed property. In either case, it seems more appropriate to tie the deduction to the actual amount that is available for charity.

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