

# WAREHOUSING WEALTH

DONOR-ADVISED CHARITY FUNDS SEQUESTERING  
BILLIONS IN THE FACE OF GROWING INEQUALITY



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## Key Findings

At a time of staggering inequality, wealthy individuals are using donor-advised funds, or DAFs, to claim substantial tax benefits, while often failing to move funds in a timely manner to independent nonprofits addressing urgent social needs. Of particular concern are the growing number of DAFs founded by for-profit Wall Street financial corporations that provide incentives for the warehousing of wealth. This report documents the dramatic expansion of DAFs and the risks an unregulated DAF system poses to the public interest and the charitable sector.

### Explosive Growth

- DAFs are now the fastest-growing recipients of charitable giving in the U.S. Donations to DAFs increased from just under \$14 billion in 2012 to \$23 billion in 2016—growth of 66% over five years. In contrast, charitable giving by individual donors nationwide grew by just 15% over the same five years.<sup>1</sup>
- DAFs appear to be shifting giving away from active charities. The share of total U.S. individual charitable giving that is going to DAFs, rather than to direct charities, has nearly doubled over the past seven years—from 4.4 percent in 2010 to 8.3 percent in 2016.<sup>2</sup>
- In 2016, for the first time ever, a DAF—Fidelity Charitable—was the top single recipient of charitable giving in the U.S. In 2017, six of the top ten recipients of charitable giving were DAFs.<sup>3</sup>
- Fidelity Charitable grew from \$1.7 billion in annual donations in 2011 to \$6.8 billion in annual donations in 2017, for total growth of more than 400 percent over seven years.<sup>4</sup> Fidelity Charitable held nearly \$16 billion in assets in 2016—more than half the total assets of all community foundations in the United States combined.<sup>5</sup>
- The average DAF donor is a member of the wealthiest one tenth of one percent of Americans, with annual income over \$1 million.<sup>6</sup> The primary attractions for the use of DAFs among the super-wealthy are the advantages related to the relief of capital gains tax burdens, and the easy donation of non-cash appreciated assets—an area of charitable giving rife with potential abuses.

## Potential Risks

- There is no legal requirement for DAFs to pay out their funds to qualified charities—ever. According to one estimate, the average annual payout rate for DAFs in 2016 was 20 percent, although some DAFs give considerably less.<sup>7</sup>
- Even as the amount of funds flowing to DAFs has increased, payout rates have been steadily going down.<sup>8</sup>
- As currently structured, DAFs encourage a wealth preservation mentality in donors, rather than incentives to move donations to qualified charities. This delays the public benefit from those donations, which has an opportunity cost for society.
- DAFs provide loopholes for both donors and private foundations to get around tax restrictions and significantly reduce transparency and accountability.
- In many cases, financial advisors are rewarded for steering their clients towards DAFs affiliated with their corporation, and financial advisors and corporate fund managers are rewarded for keeping money in DAFs once they are established.

## Recommendations and Policy Changes

This report offers several recommendations for mitigating the risks of DAFs, including:

- Require distribution of DAF donations within three years.
- Delay donor tax deduction until the funds are paid out to active charity.
- Establish a specific pay out rate.
- Bar private foundation donations to DAFs and vice versa.
- Increase scrutiny of rules around donations of non-cash appreciated assets to ensure public interest and taxpayers are protected.
- Cap management fees for commercial advisors of DAFs.
- Require that a donor's DAF cannot be managed by the same organization that handles the donor's personal assets.

## Introduction

Charitable giving is beneficial to society and can provide solutions to market failures while helping causes and people in need. While most people in the U.S. contribute to charities—be it their private foundation or the local food bank—not all receive significant tax benefits for doing so. The wealthy are more likely to claim charitable deductions, and to receive the most tax benefits as a result. Because we as taxpayers effectively subsidize the charitable giving deduction, there is a public interest in ensuring the effectiveness and efficacy of philanthropic giving as a whole.

This paper focuses on the specific charitable giving vehicles called donor-advised funds, or DAFs, which have been growing in popularity at a remarkable rate in recent years. Unfortunately, the public interest has not been upheld by the regulations addressing DAFs. By and large, DAF donors likely have no malintent; but a broken incentive system has encouraged and enabled ultra-wealthy individuals to use DAFs as a tax avoidance strategy rather than for the greater good of serving charitable needs.

The laws governing charitable giving provide a tax reduction at the moment that a donor gives up dominion and control over property, with the understanding that the property is being transferred to a recipient chartered to promote a public good.<sup>9</sup> DAFs, however, break this understanding, creating a two-step process with the DAF as intermediary. The donor first transfers funds to the DAF, and is able to claim a tax break at the moment of transfer, but then essentially retains control over grant making from that DAF to public charities.

This structure means that DAFs provide a quick, convenient way for wealthy donors to move appreciated assets without incurring capital gain taxes, and, at the same time, to receive the benefit of a tax deduction for their donation. But the public benefit from and control over these gifts are both delayed, sometimes indefinitely, since there are no requirements as to when DAFs must distribute these funds to public charities.

In addition, the incentive system surrounding DAFs contributes to a fog over the distinction between what is personal and what belongs to society. It encourages donors to enter into a capital preservation mindset, in which they view their charitable fund as another form of private wealth to preserve, grow, and even pass on to children as a legacy.

We discuss these dynamics and many more in the pages ahead, as well as present pragmatic policy solutions to reform aspects of DAFs that do not serve the public good.

## What Are Donor-Advised Funds?

A donor-advised fund, or DAF, is a collection of financial assets, such as cash, stocks, and bonds, that is owned and managed by a charitable organization, and is used solely for the purpose of making grants to other charities. As with a private foundation, donors may take advantage of the charitable tax deduction upon transferring funds to a DAF, before those funds ever go to a public charity. What sets DAFs apart is that they have fewer accounting restrictions than a private foundation and greater tax benefits.

Any charitable organization that manages a donor-advised fund is called a sponsor, and must be registered with the Internal Revenue Service as a 501(c)(3) public charity.<sup>10</sup> Individual donors can set up any number of separate funds with a sponsor, and make tax-deductible contributions to those funds.

The sponsoring organization has complete legal ownership over any contributions donated to it, but it allows its donors to advise them in two key ways: which charities they want the grants from their funds to go to and when those grants should happen.<sup>11</sup>

Sponsors are not legally required to follow their donors' grant recommendations, but in practice they almost always do.<sup>12</sup> For this reason, the *Chronicle of Philanthropy* has described donor-advised funds as being, for all intents and purposes, "charity checking accounts."<sup>13</sup>

The charitable giving industry generally divides DAF sponsors into three types: single-issue charities, community foundations, and national sponsoring organizations.<sup>14</sup>

- **Single-issue charities** are those that support one specific cause—an issue, an institution, or a faith. The Sierra Club Foundation, Stanford University, and the Combined Jewish Philanthropies of Greater Boston are all single-issue charities that sponsor donor-advised funds. These charities are usually involved in a range of other fundraising activities in addition to donor-advised funds, so that DAFs make up just a small portion of their overall revenue.
- **Community foundations** are sponsors that are place-based in focus, directing their grants toward a specific geographical region such as a city or a state. The Chicago Community Trust and the Foundation for the Carolinas are examples of community foundations that sponsor donor-advised funds. Donor-advised funds usually make up a larger portion of the assets of community foundations than they do for single-issue charities.

- **National sponsoring organizations** are not tied to a specific cause or region, and distribute grants nationwide. The Fidelity Charitable Gift Fund and Schwab Charitable are examples of this type of sponsor. For these organizations, administering donor-advised funds is their primary, and often only, charitable activity.<sup>15</sup>

It is worth noting that national sponsoring organizations are different from the other two types of sponsors in fundamental ways. Rather than serving as one element of an integrated fundraising strategy working towards an established philanthropic goal, **national sponsors were created solely for the purpose of donor-advised fund management.** Although national sponsors are themselves registered with the IRS as public charities, they are usually closely affiliated with for-profit corporations. For example, the funds held in the Fidelity Charitable Gift Fund, a DAF, are managed by Fidelity Investments, the for-profit financial services corporation that created the DAF.

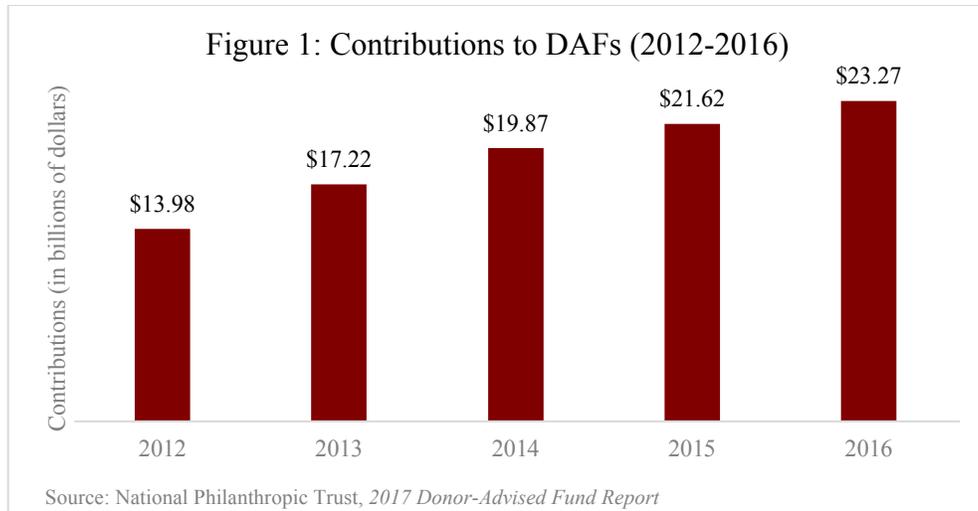
Roger Colinvaux, a law professor at The Catholic University and expert on DAFs, explains that for many national sponsors, “raising funds through a DAF is the reason the charity exists—i.e., the DAF as a fundraising device is the end, not a means.” As Colinvaux says, this is “a significant departure from the historical norm, in which DAFs were housed within a charity that had a distinct charitable mission.”<sup>16</sup>

Consequently, as we will discuss later in this report, national sponsoring organizations may warrant different sorts of oversight than the other two types of DAFs.

## Growth of Donor-Advised Funds

Donor-advised funds have existed since the 1930s, when they were first created by community foundations. Giving to DAFs did not ramp up in earnest until the 1990s, however, when commercial financial services companies, including major players such as Fidelity Investments and the Charles Schwab Corporation, created their own not-for-profit DAF-sponsoring organizations.

Since then, DAFs have exploded in popularity. As a sector, they are now the fastest-growing recipients of charitable giving in the United States. According to the National Philanthropic Trust’s *2017 Donor-Advised Fund Report*, annual **donations to DAFs increased from just under \$14 billion in 2012 to \$23 billion in 2016—growth of 66% over five years.**<sup>17</sup>



Over the most recent two decades, in fact, DAFs have seen such phenomenal growth that some of them—in particular, corporate-affiliated national sponsors—are now among the largest single recipients of charitable giving in the country.

Every year, the *Chronicle of Philanthropy* releases its Philanthropy 400, a ranking of the four hundred U.S. charities receiving the most donations in that year. In 2016, for the first time in the list’s 25-year history, a donor-advised fund was the top recipient of individual giving: the Fidelity Charitable Gift Fund’s \$4.6 billion in donations edged the United Way out of the top spot.<sup>18</sup> Fidelity remained in that position in 2017, and that year the *Chronicle* reported that six of the top ten on its list were DAFs—worth more than \$13 billion combined annually.<sup>19</sup>

**Figure 2: Top 10 Recipients of Charitable Giving Revenue (2017)**

Rank	Organization	Revenue
1	Fidelity Charitable Gift Fund	\$4,076,302,537
2	United Way Worldwide	\$3,539,672,346
3	Goldman Sachs Philanthropy Fund	\$3,190,157,926
4	The Task Force for Global Health	\$3,155,468,284
5	Feeding America	\$2,375,635,807
6	Schwab Charitable Fund	\$1,922,695,881
7	Salvation Army	\$1,882,744,000
8	National Christian Foundation	\$1,532,256,000
9	Silicon Valley Community Foundation	\$1,383,888,000
10	Vanguard Charitable Endowment Program	\$1,278,868,232

Shaded boxes designate DAFs

Source: *Chronicle of Philanthropy*, "How Much America’s Biggest Charities Raise: 27 Years of Data", October 31, 2017

The amount of revenue flowing into donor-advised funds is impressive, and the growth in that revenue is unprecedented.

In contrast, according to the Giving USA Foundation, charitable giving by individual donors to all recipients nationwide grew by just 15 percent over the past five years—from about \$244 billion in 2012 to just under \$282 billion in 2016.<sup>20</sup> In other words, **over the most recent five years for which there is data, giving to donor-advised funds grew more than four times faster than individual giving in the United States as a whole.**

The result is that DAFs have not only grown in sheer volume; they have also significantly increased their *share* of charitable giving. In their *2017 Donor-Advised Fund Report*, the National Philanthropic Trust reported that **DAF donations made up only 4.4% of all individual giving nationwide in 2012, but made up 8.3% of individual giving in 2016—nearly doubling their share of the charitable pie in just five years.**<sup>21</sup> There is no indication that as wealth concentrates in fewer hands this trajectory will not continue.

These combined trends support the contention of some in the industry that the extraordinary recent growth in DAF giving is not increasing charitable giving in general, but is instead *shifting* donations away from traditional mission-based charities. We will discuss this later in this report.

## The Perils of Top-Heavy Philanthropy

Charitable giving has risen to new heights over the last two years. According to *Giving USA 2018*, total donations rose to over \$410 billion in 2016, a 5.2 percent jump over 2015.

But these unprecedented levels of donations mask a troubling trend. Nonprofits are increasingly reliant on larger donations from a smaller number of high-income, high-wealth donors. Meanwhile, charities are receiving shrinking amounts of revenue from the vast population of donors at lower and middle-income levels.

A 2016 report by the Institute for Policy Studies, [\*Gilded Giving: Top Heavy Philanthropy in an Age of Extreme Inequality\*](#), warned that we are moving toward a philanthropic sector dominated and directed by wealthy mega-donors, their foundations, and donor-advised funds.

These philanthropic trends mirror several decades of growing wealth and income inequality in our society as a whole. Charitable contributions from wealthy donors have increased significantly over the past decade, as our report revealed.

Meanwhile, charitable giving by low and middle-income donors has declined significantly. According to Target Analytics, which produces one of the only longitudinal data sets on donor counts available, the number of donors giving at typical donation levels has been steadily declining over the past ten years.

If these trends continue, we are headed for an increasingly “top-heavy” structure in which wealthy donors reshape the philanthropic sector while also shifting billions away from taxation. Top-heavy philanthropy will mean increased volatility and unpredictability in funding, making it more difficult to budget income into the future. Independent sector organizations will increasingly need to shift toward major donor cultivation and retention at the expense of small donor diversification. Top-heavy giving will likely benefit larger nonprofit institutions with advanced development offices and donor perks, such as building naming rights. And the increasing power of a small number of wealthy donors increases the risk of mission distortion.

There are perils for the wider civil society as well. Concentrated wealth philanthropy has the potential to form blocks of private unaccountable power—essentially serving as an extension of personal power, privilege, and influence for a handful of wealthy families.

## DAFs Are Growing in Most Other Metrics As Well

DAFs are not just receiving more contributions; they also have significant growth in most other measures as well. The National Philanthropic Trust reported that from 2015 to 2016 (the most recent years for which they have data), DAFs nationwide experienced growth in their number, their total assets, their average size, and the total amount of dollars they gave out each year in grants.<sup>22</sup>

- 6.9% growth in the number of DAFs (from 204,704 in 2012 to 284,965 in 2016)
- 9.7% growth in assets under management (from \$44.71 billion in 2012 to \$85.15 billion in 2016)
- 10.4% growth in grants paid out (from \$8.50 billion in 2012 to \$15.75 billion in 2016);
- 2.6% growth in their average size (from \$218,413 per DAF account in 2012 to \$298,809 per DAF account in 2016)

The one area in which DAFs are arguably declining is in their payout rate, which we will address in more detail later. There is considerable disagreement on the methods used to calculate payout, which is one of the most important, and contentious, metrics used to evaluate donor-advised funds.

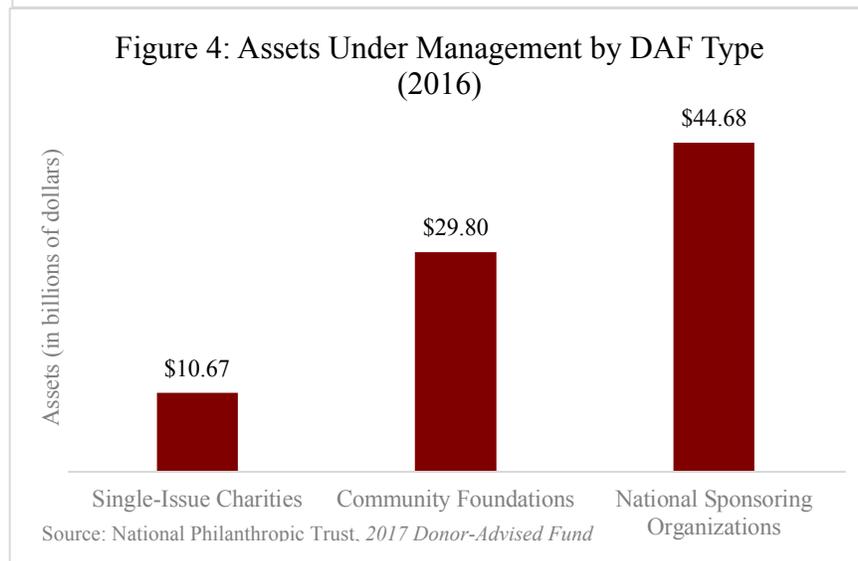
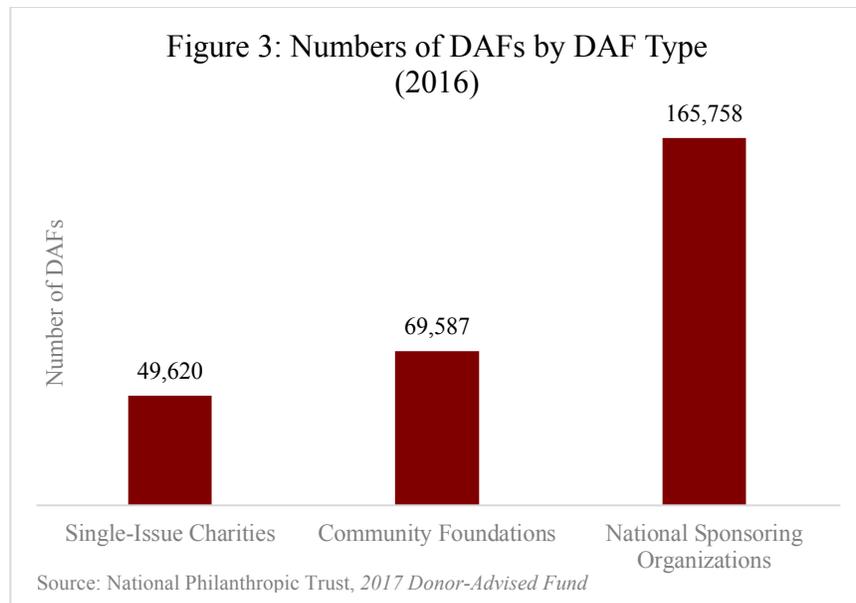
## Growth Varies Considerably by DAF Type

DAFs as a group have experienced dramatic growth in recent years, but that growth varies quite a bit across the three types of DAF sponsors.

- According to the National Philanthropic Trust (NPT), giving to DAFs sponsored by **single-issue charities** increased about 32% over the most recent five years covered by their latest report, from \$2.43 billion in 2012 to \$3.20 billion in 2016. This is much slower growth than either of the other two types of DAF sponsors, and may reflect the fact that, as the NPT speculates, many single-issue charities are in the process of closing DAF programs, and may be spending them down or merging with larger charities. There are also many fewer of these charities and they have fewer assets under management than either of the other two sponsoring types; there were 49,620 single-issue charity DAF sponsors with a total of about \$11 billion in assets in 2016.<sup>23</sup>

- Giving to DAFs hosted by **community foundations** increased about 24% over the same five years, from \$4.57 billion in 2012 to \$5.66 billion in 2016. There are more community foundations than there are single-issue charities in the United States and they have almost three times more assets than single-issue charities do (69,587 community foundations had \$29.80 billion in assets in 2016).<sup>24</sup>
- The growth of single-issue charities and community foundations has been dwarfed, however, by the growth of DAFs hosted by **national sponsoring organizations**—in both numbers and revenue. **Giving to national sponsors increased 107% in five years, from \$6.97 billion in 2012 to \$14.41 billion in 2016.** The 165,758 DAFs at national charities had \$44.68 billion in total charitable assets under management in 2016.<sup>25</sup>

The single largest national sponsoring organization, the Fidelity Charitable Gift Fund, held, by itself, nearly \$16 billion in assets in 2016—more than half the total assets of all community foundations in the United States combined.<sup>26</sup> Fidelity Charitable grew from \$1.7 billion in annual donations in 2011 to \$6.8 billion in annual donations in 2017 for total growth over 400 percent.<sup>27</sup>



## Who Gives to DAFs?

The Fidelity Charitable Gift Fund positions itself as a giving vehicle designed to “democratize giving;” to “empower more Americans to give more to the causes they care about.”<sup>28</sup> Many other DAFs make a similar appeal: that since it is relatively inexpensive to set up a donor-advised fund, a wide range of people can participate in this long-term, account-based mode of giving. They argue that DAFs provide a convenient giving alternative for people who do not have enough money to start a

private foundation, enabling them to give to charity where they may not have done so otherwise.

While it is true that DAFs are less expensive to set up than private foundations, to position them as democratizers of philanthropy may be a bit of a stretch. The minimum starting balance required to set up a DAF at many of the largest funds in the country—including Fidelity Charitable, Schwab Charitable, and Bank of America—is \$5,000. Other sponsors, even small ones, may require a starting balance of \$10,000 or more. And once a DAF is established, donors are subject to annual management fees and minimum additional deposit requirements.

## **Income Levels of DAF Donors**

James Andreoni, a professor of economics at the University of California at San Diego, wrote an analysis of the costs and benefits of donor-advised funds in collaboration with the National Bureau of Economic Research in 2017. As part of his analysis, he used IRS data to create models to determine the average income levels of people giving to DAFs.

He discovered two things. The first is that, according to his models, the income level of the typical DAF donor is staggeringly high. The other is that—in contradiction to the idea of DAFs as a democratizer of philanthropy—the wealthier a person is, the greater benefits they will reap from having a DAF.

Andreoni used two methods to predict the income level of DAF donors: one used the average grant amount *from* a DAF and one used the average contribution amount *to* a DAF. Using grants, Andreoni's model predicted that **the average DAF donor had an income of over \$1.3 million per year. Using contributions, his model predicted an average income of over \$2.1 million per year.**<sup>29</sup>

For context, the top 1 percent of the United States population by income includes 2.34 million adults who each make at least \$458,000 in pre-tax income. The average DAF donor is actually a member of the smaller, more elite, top 0.1 percent of the population. This group includes just 234,000 people who each make at least \$1.96 million in total household income.<sup>30</sup>

Andreoni adds that both of these predicted income amounts assume that every donor has only one DAF. The more DAFs a single donor has, on average, the higher those predicted income levels would be. Fidelity Charitable, for one, reports that its donors

have an average of 2.5 donor-advised funds, so it is likely their donors' income levels are high indeed.<sup>31</sup>

## Capital Gains Tax Benefits to DAF Donors

The high income levels of DAF donors may be only natural, given the reason many people choose to set up DAFs in the first place. According to Andreoni's analysis, **the greatest financial benefit that DAFs offer to their donors is in avoiding capital gains taxes.** If a person is anticipating a large capital gain in a given year—from a merger or an initial public offering, for example—they can donate some of their shares of stock to a DAF before the sale, and use the deduction from that gift to offset thousands or even millions of dollars in capital gains taxes. Additionally, the tax benefit from DAF giving increases significantly with the amount of capital gains one has to avoid; the higher the donor's adjusted gross income is, the greater their deduction for their charitable DAF gift will be.<sup>32</sup>

It makes sense, therefore, that the typical DAF donor is likely to be a person who is in a position to benefit greatly from mergers or IPOs, or who holds large amounts of assets in the form of appreciated equities, artwork, or real estate. These are high-income, high net worth people. Most U.S. taxpayers do not incur capital gains each year, much less earn enough to pay capital gains taxes if they do incur them. Thus, as Andreoni says, **"this means there is no opportunity to benefit financially from DAFs for well over half of the US taxpaying population."**<sup>33</sup>

As evidence that people frequently use DAFs to reduce or eliminate capital gains taxes, Andreoni points to the sizes of the DAFs themselves. "It is surprising to look at an annual giving report from Fidelity Charitable, for example," he says, "and learn that 8% percent of DAF accounts carry balances over \$250,000. This balance in a DAF is hard to imagine without inferring these belong to people who are avoiding capital gains tax that, in the absence of DAFs would be more difficult to avoid."<sup>34</sup>

Donors of appreciated property to DAFs receive a significantly greater tax subsidy from U.S. taxpayers than donors of cash directly to charities. As Professor Ray Madoff writes,

*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).<sup>35</sup>*

For every dollar of appreciated assets donated to a DAF, then, U.S. taxpayers are providing as much as 57 cents of subsidy in the form of lost tax revenue. These taxpayers must pick up the slack in paying for public services such as veterans' health care, infrastructure, national parks, and defense.

## **DAF Grant Alignment with High-Net-Worth Giving Patterns**

The *types* of grants given out by DAFs provide further evidence that DAF donors are, in general, people of high net worth.

For the past twelve years, U.S. Trust and the Lilly Family School of Philanthropy at Indiana University have collaborated to produce *The U.S. Trust Study of High Net Worth Philanthropy*, an annual report on giving by high-net-worth donors. In 2017, the Lilly School also produced *The Data on Donor-Advised Funds: New Insights You Need to Know*, a report that gives us a bit more insight into the granting behavior of DAF donors for the first time.

As part of their 2017 report, the Lilly School compared the giving patterns of DAF donors with the giving patterns of the nation as a whole, and with those of the high-net-worth donors in the U.S. Trust report. They found that DAF distributions differed from overall national giving patterns in key ways. A *larger* proportion of DAF grants went to education, the arts, and international organizations than those sectors tend to receive from the population as a whole. And a *smaller* proportion of DAF grants went to religious organizations than that sector receives from the population as a whole.<sup>36</sup>

In these differences, DAF granting aligns more closely to the giving patterns of high-net-worth donors than it does to the typical U.S. donor. According to the 2014 U.S. Trust report, education was the sector that received the most dollars from high-net-worth donors<sup>37</sup>, as well as the most dollars from DAF grants. And religious organizations received similar and disproportionately smaller percentages of the dollars given by both high-net-worth individuals and DAF grants.<sup>38</sup>

## **Donor-Advised Fund Payout Rates**

A donor-advised fund's payout rate is, at its most basic, the speed with which money comes out of the DAF and goes into the hands of its grantees. This makes payout rate one of the most important measures of donor-advised fund giving, and one of the most contentious as well.

It is a common critique of DAFs that they may actually be functioning less as real charities, and more as warehouses of assets for the wealthy. Organizations that sponsor DAFs are defensive about this criticism, since their tax-deductible status rests on the principle that they are simply a vehicle for transferring money from donors to worthy charities. A high payout rate can provide a sponsor with evidence that the donations coming into their funds are being paid out at a relatively fast clip, and that they are therefore fulfilling their charitable purpose.

Payout rate, however, is a slippery animal. Analysts, economists, the IRS, and DAF sponsors themselves calculate it a number of different ways, and the results can vary quite a bit depending on the formula used.

### **Common Payout Rate Formulas**

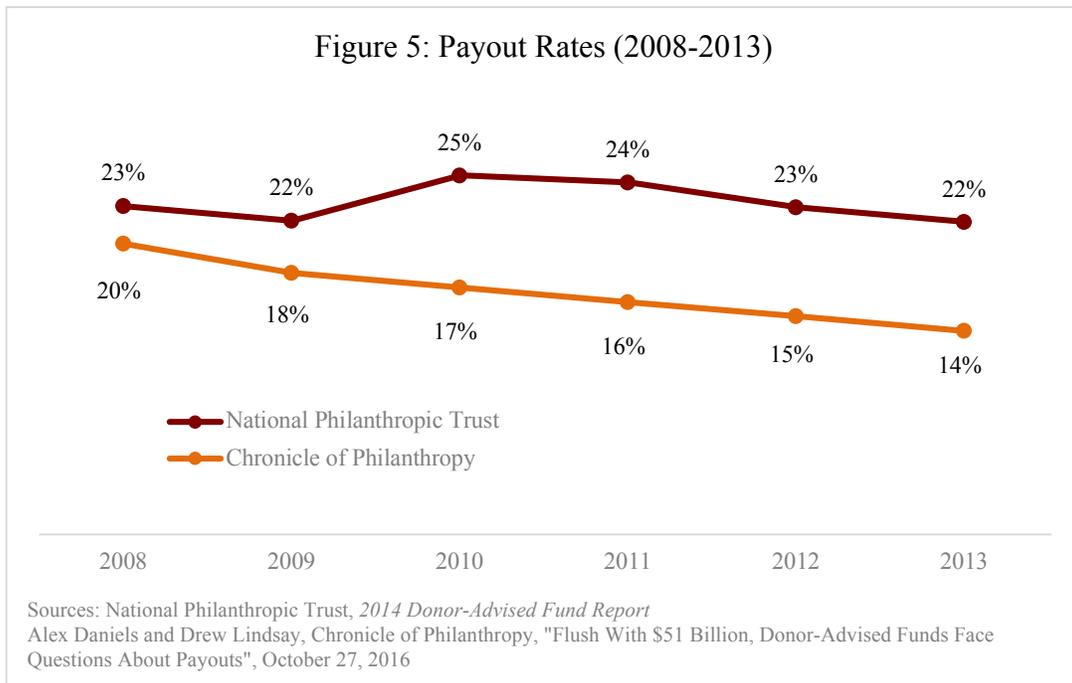
A more detailed analysis of various payout rate calculations can be found in the Appendix at the end of this report, but the industry's three most common formulas are as follows:

- The National Philanthropic Trust currently calculates payout rates for its annual report on DAF giving by dividing the total dollars paid out in grants in a year by the total value of the assets in the funds at the beginning of the year. Many other DAFs use this same method as well.<sup>39</sup>
- Other DAFs calculate payout rates by dividing the total dollars paid out in grants by the total value of the assets in their funds at the end of the year, rather than the beginning.<sup>40</sup>
- The Internal Revenue Service and the *Chronicle of Philanthropy* both use a third way of computing the total dollars held in assets by DAFs: they divide the total dollars paid out in grants by the total dollars held in assets at the end of the year, plus any grants made during that year.<sup>41,42</sup>

### **Declines in Payout Rates**

The *Chronicle of Philanthropy* and the National Philanthropic Trust both regularly publish nationwide metrics about donor-advised fund giving, including payout rates. Because they use different formulas for calculating those rates, their numbers are somewhat different. Regardless of the calculation used, however, DAF payout rates have generally been going down over the past decade.

The Chronicle’s data shows a distinct, regular decline in payout rates, from 20% in 2008 to 14% in 2013 (the most recent years available).<sup>43</sup> NPT’s rates held steadier over this period, dropping only from 23% in 2008 to 22% in 2013, but show steeper declines in more recent years. In their 2017 DAF analysis, they reported that payout rates peaked at 25% in 2010 but have been dropping each year since, reaching a low of 20% in 2016.<sup>44</sup>



Payout rates for some of the largest national sponsors in the country have dropped particularly precipitously in recent years. Using the IRS’s methodology, the *Economist* calculated that “Fidelity [Charitable]’s annual payout rate dropped from 21% to 16% between 2008 and 2014, the latest year of available data. Those of Schwab and Vanguard fell from 18% to around 11%.”<sup>45</sup>

Payout rates are not declining because DAFs are giving out fewer dollars in grants. The gross dollar amount of DAF grants has actually grown by 85% over the past five years, from \$8.50 billion in 2012 to \$15.75 billion in 2016.<sup>46</sup> The reason that payout rates are declining is because the assets held in DAF accounts have been increasing even faster: DAF assets have grown by 90% over the same five years. Each year, then, as the funds increase in value, a smaller proportion of those funds goes out to organized charities.

## Benefits of DAFs

Donor-advised fund sponsors are understandably quick to extol the benefits of setting up a fund at a DAF. Some of the advantages that they often list include benefits that are not unique to DAFs, such as the convenience of making payments online, and making it easy to budget giving for the future. But DAFs do offer unique advantages, of both financial savings and of convenience, to those who can afford them.

### Benefits for Donors

- For those who have a good deal of disposable income and the desire to give to charity using a long-term giving vehicle, **opening a DAF is less expensive** and requires less administrative overhead than establishing a private foundation. They require less of an initial contribution; the fees are lower; and the sponsoring organization takes care of all the grant administration and the fund management activities.<sup>47</sup>

In return, the donor relinquishes all legal control over their donation and maintains only the right to recommend where the grants from the DAF should be directed. Officially, the sponsor has no obligation to heed that recommendation. But this is, of course, an illusory independence; any DAF that violated donor intent would be out of business immediately. This advisory arrangement thus satisfies the IRS requirement that the asset has been separated from the donor, but still allows the donor to retain, for all intents and purposes, administrative control over grants.

- **DAFs have no minimum annual distribution requirement**, as exists for private foundations. To ensure that money is distributed from foundations to charities in a timely manner, the federal government requires them to distribute a minimum of 5 percent of their assets each year in grants to nonprofits. DAFs, however, have no payout requirement. This means that it is entirely up to the donor and the sponsoring organizations how quickly they choose to pay out the assets held in their funds.<sup>48</sup>
- **DAFs are not subject to the same excise taxes** that private foundations are subject to. Most foundations must pay excise taxes of up to two percent of their income on investments, but DAFs do not.<sup>49</sup>

## Benefits for Tax Savings

- According to economist James Andreoni, who authored what is perhaps the definitive analysis on the costs and benefits of DAFs, **the primary financial benefit that DAFs offer to their donors is that of capital gains tax savings.** DAFs provide a quick, convenient way to transfer appreciated assets without incurring capital gains, and, at the same time, to receive the benefit of a tax deduction for their charitable donation.

As evidence of the attractiveness of donating appreciated assets to DAFs, Andreoni showed that DAF donors' contributions consist of about 15% more in capital gains assets than do the contributions of donors giving directly to charity. He also found "clear evidence of a surge of demand for DAF accounts when there is a greater value to escaping capital gains taxation."<sup>50</sup>

Andreoni's case study for this was tax law passed under President Obama that took effect in 2013, which increased the top tax rates on both income and long-term capital gains. Ordinarily, increases in tax rates result in increased charitable giving, with taxpayers using the charitable deduction as a way to reduce their taxes.<sup>51</sup> When Andreoni looked at DAF donors' responses to the 2013 law, however, he found that the changes in the tax rates only "mildly" increased their overall level of charitable giving. Instead, DAF donors *shifted* their giving, switching from cash gifts to non-cash gifts of appreciated assets. They also began opening new DAF accounts, at more than double the rate that they had been opening them before.<sup>52</sup>

- **Donations to DAFs are not subject to the same cap on tax deductibility** as donations to private foundations. When giving to a DAF, depending on the types of assets they donate, donors can deduct anywhere from 30% to 60% of their adjusted gross income for the gift. When giving to a private foundation, they can only deduct 20% to 30%.<sup>53</sup>
- **DAFs make it easier to donate non-cash assets that are hard to value.** This may include assets such as artwork, real estate, or privately-held company stock. When these assets are donated to a DAF, the donor hires a third-party appraiser to value them; the vast majority of the time, the DAF accepts the valuation of the donor's appraiser unchallenged, and the donor is able to take a tax deduction for the full assessed value. If they had had to sell these assets themselves, it would make the process much harder on the donor; and if they had donated these

assets to a private foundation instead, they would have only been able to take the deduction for their basis value, rather than their assessed value.<sup>54</sup>

As evidence that this feature of DAFs is an appealing one to donors, the *Economist* magazine reported that in 2013, roughly 28% of all donations to DAFs were of non-cash assets.<sup>55</sup> And Fidelity Charitable said in their *2016 Giving Report* that fully *two-thirds* of their 2015 contributions were in the form of non-cash assets.<sup>56</sup>

- Law professors and DAF experts Ray Madoff and Roger Colinvaux point out another advantage of DAFs: **they allow the donor to time their charitable giving** to get the maximum tax deduction at the most advantageous time for them. If a donor knows that their income level will be significantly higher in one year than another, for example, they can donate a large amount to a DAF in a year when their tax bracket is higher and they will gain greater benefit from the deduction. They will then still retain the ability to recommend charitable donations from that DAF in future years when their tax bracket may be lower.<sup>57</sup>

## Potential Negative Aspects of DAFs

Donor-advised funds assuredly offer financial and convenience advantages to those who can afford them, and who want to reduce their tax obligations or extend the distribution period of their charitable gifts. And, for decades, the community foundations and single-issue organizations who originally developed DAFs as a giving vehicle have been using them to channel millions of dollars to public charities.

In 1991, corporate-affiliated national sponsoring organizations entered the arena for the first time. They were a whole new breed of DAF: technically nonprofit, but able to access the fund management infrastructure, prospective customer base, and marketing power of the financial service industry companies that founded them. Unattached to any charitable mission of their own—be it a geographic location, a cause, or an institution—their primary purpose was the fund management and administration itself.

Less than twenty-five years after the founding of the first national sponsor, the Fidelity Charitable Gift Fund, DAFs have sped to the top of the nonprofit recipient world. In 2016, they were six of the top ten recipients of private donations in the United States, including the top single recipient.<sup>58</sup> They raise billions of dollars every year, and have billions more under management.

The rapid growth of donor-advised funds, particularly those affiliated with corporate entities, has raised questions about their nature as public charities and the degree to which the public is being served by their activities. There are concerns that the dollars going into DAFs may stay undistributed for years—warehousing dollars that otherwise often would have gone directly to active nonprofits. And there are concerns that DAFs may be ripe for abuse, serving as loopholes for people looking to get around personal tax restrictions or the restrictions on private foundations.

We believe that these concerns are legitimate, and that without proper oversight, donor-advised funds pose risks in three main areas: risks to the public interest, risks to active charities, and risks to the DAF donors themselves.

## **Risks to the Public Interest**

The chief risk to the public interest from DAFs is that their cost to society may be greater than their benefit.

By definition, donor-advised fund sponsors must be 501(c)(3) charities registered with the Internal Revenue Service. This is what enables their donors to take a tax deduction for their gifts.

Any tax deduction is a cost to the U.S. taxpayer; it reduces the amount of revenue available each year to spend on public programs. It is, essentially, a subsidy from the public to the person taking the deduction. To warrant the subsidy, therefore, a tax deduction must provide a benefit to society that outweighs its cost.

In the case of the charitable deduction, the bargain that was struck with the public was that in exchange for their donors getting a deduction for their gifts, the charity's work would benefit the public as a whole, and not any single individual.<sup>59</sup> When a donor uses the U.S.-government-created charitable deduction to reduce their taxes in exchange for a gift, we, as taxpayers, are effectively providing matching funds for that gift. For every dollar a billionaire gives to charity, the taxpayer has to supply between 37 and 57 cents to make up for lost tax revenue.<sup>60</sup>

Donors may believe that their donations shouldn't be subject to scrutiny. **But it is in the public interest to ensure that revenue claimed for a tax deduction is being used for the purposes for which the deduction was intended—and this justifies oversight and accountability from both donor and recipient.** If a donor wishes to avoid this oversight, they are free to give donations without claiming deductions.

“There is a clear federal interest in protecting against abuse of the charitable deduction,” writes Roger Colinvaux. “Because donors receive a charitable deduction for DAF contributions, the federal government has an interest in ensuring that the funds are not directed to private use. In addition, the government has a stake, not simply as a matter of taxation, but as a matter of the public interest, in helping ensure a reasonably efficient and equitable system of private charity.”<sup>61</sup>

Unfortunately, it appears that, in many cases, we are neither getting a good return on the DAF donations we subsidize—nor are the donations always being used solely for society’s benefit.

**The donor’s interests are served immediately, but society’s interests are only served when the grants come out of the DAF.**

- **DAF giving postpones the public benefit from charitable deductions.**

Donors are able to take a tax deduction for the entire value of their donation as soon as their donation goes into a DAF. But, as law professor Ray Madoff and philanthropist Lewis Cullman point out, the “public value of DAFs does not occur until such time as funds come out of the DAF sponsor and make their way to active charities.”<sup>62</sup> In other words, the donor’s interests are served immediately when their donation goes into a DAF. But society’s interests are only served when the grants come out of the DAF and are granted to charities working directly on issues for the public good.

Economist James Andreoni, in his report on the costs and benefits of DAFs, performed an analysis that showed that it takes an average of three years before a donation to a DAF begins to be drawn down, and an average of four years until it is fully paid out.<sup>63</sup> And that is an *average*; since donor-advised funds have no minimum annual distribution requirement, it can be a very long time before money put into any individual DAF is actually granted out to charities on the ground. Thus the taxpayer may have to wait for years—or potentially forever—to even begin to see some kind of return on their investment in DAF donations.

- **Indirect giving through DAFs has opportunity costs for society.**

James Andreoni also points out that giving to charity has certain “features of an investment,” including a quantifiable return on that investment.<sup>64</sup> He writes that giving directly to a public charity usually results in a considerably higher return

to society at large than giving to a DAF and then parceling out grants to the same charity later, over a longer time period.

One example of this comes from the research of economist and Nobel Prize winner James Heckman, who analyzes the benefits of money spent on early childhood development programs. Heckman estimates that every dollar invested in programs for children from birth to age five results in a 13% average return for society as a whole, in terms of better outcomes in education, health, crime, and employment.<sup>65</sup>

A strong case can be made, therefore, that as inequalities of income, wealth, and opportunity grow, the sooner funds are invested in reversing these inequalities, the quicker destructive patterns and barriers are overturned.

The faster money is able to get into these early childhood development programs, for example, the more children they will be able to reach sooner, and the greater return the public will see. If a donor that otherwise would have given directly to a child development charity gives that money to a DAF instead, and grants the money out more slowly, the return from their gifts to society is lessened considerably.

- **DAFs provide loopholes for foundations to get around tax restrictions.**

As we said earlier, private foundations are required to pay out at least 5% of their assets to charity each year. Donor-advised funds, on the other hand, have no payout requirement.

Currently, private foundations are able to fulfill their minimum payout requirement by giving gifts to donor-advised funds. This type of granting may not be common, but it does happen. The *Economist* magazine analyzed grants from roughly 4,000 private foundations and found that a noticeable chunk of the donations coming from those foundations did not actually go to active charities, but into DAFs instead. "Some 40 of them routed cash to the biggest DAF providers," the *Economist* reported, "amounting to about 1% of the value of all their contributions. This may seem like a negligible sum, but 11 of the 40 gave over 90% of the money they paid out to DAF suppliers."<sup>66</sup>

It is questionable, to say the least, whether gifts to DAFs really should qualify as charitable giving for the purposes of foundation disbursements. The foundation payout requirement was enacted specifically to ensure that assets are distributed

in a timely manner. But when those assets are distributed to DAFs, they are effectively transferred from an institution with a payout requirement to another institution from which there is no guarantee they will ever be paid out at all. This creates a strong temptation for foundation donors to use DAF giving to get around their minimum payout requirement, while still essentially retaining control over the money.

**Another drawback to allowing DAF giving by foundations is that it significantly reduces transparency and accountability.** Foundations must disclose where their grants go, but DAFs do not. If a foundation donor wanted to mask their giving, it would be easy for them to do so by transferring their money from their foundation to a DAF, and then directing the DAF to make the grants instead. As industry consultant Alan Cantor says, “Donor-advised funds give foundations a way of technically meeting the 5-percent distribution requirement while essentially hiding their grant making from public view...the public has no idea where the money eventually goes, or even if it goes to a charity at all.”<sup>67</sup>

Madoff and Colinvaux say that DAF granting is a loophole that allows private foundation donors not only to avoid the minimum payout requirement, but also to mask the origin and destination of grants. “We are concerned,” they write, “that these transfers are not necessary to secure charitable ends, but serve other goals, either to avoid the payout requirement or private foundation disclosure rules. In our view, neither of these reasons is consistent with the spirit of the rules that have governed private foundation conduct since 1969. The payout is intended to measure distributions to active charities, not to other investment funds.”<sup>68</sup>

- **DAFs provide loopholes for donors to get around tax restrictions.**

Donors can not only avoid tax-related restrictions by granting from private foundations to DAFs; they are able to get around other tax restrictions by granting *from* a DAF *to* private foundations as well.

As we discussed earlier, donations to DAFs are not subject to the same cap on tax deductibility as donations to private foundations. Donors can deduct a significantly higher percentage of their adjusted gross income for their gift when they give to a DAF than when they give to a private foundation.<sup>69</sup> If a donor wants to have a gift end up in their private foundation, but also wants to get around the deductibility cap, they can first give the gift to a DAF, take the

maximum deduction, and then later direct the DAF to grant that money to their foundation.

## **Risks to Public Charities and the Independent Sector**

One of the greatest virtues of donor-advised funds, their sponsors claim, is that they increase overall giving to charity. DAF sponsors spend a good deal of energy touting this in their annual reports and promotional literature. “For as long as survey records of Fidelity Charitable donors have existed,” Fidelity Charitable said in their 2016 *Giving Report*, for example, “two-thirds of donors have consistently said they give more because of their donor-advised fund.”<sup>70</sup>

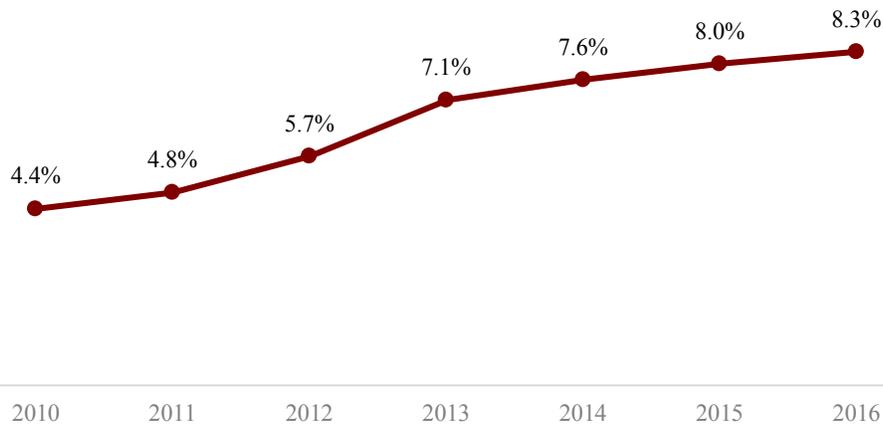
As we have seen, donor-advised funds, particularly corporate-affiliated DAFs, have grown considerably faster than any other charitable sector in recent years. But their growth has taken a greater *share* each year out of what may be a relatively static charitable giving pool. This raises concerns that as DAFs pull in more fundraising dollars, traditional direct charities may be losing out.

- **DAFs appear to be shifting giving away from active charities.**

There is no sign that DAFs are actually increasing charitable giving. According to the Giving Institute’s *Giving USA 2017* report, individual charitable giving in the United States has stayed consistently at two percent of disposable income for the past forty years. In that entire time, giving has never varied from that 2% mark by more than three-tenths of a percent more or less, and the greatest variances have happened only at times of extreme economic boom or bust.<sup>71</sup>

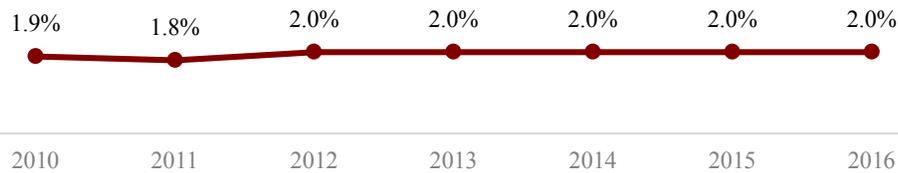
While charitable giving has remained essentially constant as a share of disposable income, the proportion of that charitable giving going to DAFs has grown substantially. In just the past seven years, the National Philanthropic Trust reports that giving to donor-advised funds almost doubled as a share of all individual giving, increasing from 4.4% in 2010 to 8.3% in 2016.<sup>72</sup>

Figure 7: Contributions to DAFs as a Percentage of Total U.S. Individual Giving



Source: National Philanthropic Trust, *2017 Donor-Advised Fund Report*

Figure 8: Total U.S. Individual Giving as a Percentage of Personal Disposable Income



Source: *Giving USA: The Annual Report on Philanthropy for the Year 2016 (2017)*. Chicago: Giving USA Foundation™

Over the past decade, then, donor-advised funds have indeed increased charitable giving—to donor-advised funds. And, as Ray Madoff and Roger Colinvax wrote in a 2017 letter to the U.S. Senate pleading for DAF reform, this growth has come at the expense of traditional charities. “Despite the tremendous growth of contributions to DAFs,” they wrote, “charitable giving has remained flat at roughly two percent of disposable personal income. This suggests that

DAFs are not increasing overall giving, but instead are attracting dollars that would otherwise be contributed directly to active nonprofits.”<sup>73</sup>

Economist James Andreoni concurs, saying that in his models, “there is little evidence that DAFs are encouraging significantly more giving over a policy of no DAFs.” He found instead that DAF donors tend to use DAFs “more heavily for tax arbitrage than as a means for behaving more charitably.”<sup>74</sup> Andreoni’s research indicates that there has been a *shifting* of charitable giving from cash to non-cash assets, and from direct charitable giving to DAF giving, but not a perceptible DAF-related *increase* in charitable giving overall. Both of these shifts indicate that tax advantages may be, in many cases, more of a motivator of DAF giving than an overwhelming enthusiasm for philanthropy.

- **Delayed giving is reduced giving.**

Proponents of DAFs are quick to point out that even though a donor’s gift does initially go into a donor-advised fund, that money is still destined to be granted out to worthy charities down the road. But the DAF almost always waits for a donor’s recommendations before giving out grants, which delays giving from the outset. Also, rather than giving a lump sum gift immediately to a direct charity, a DAF donor may choose to grant that same gift out piecemeal over many years instead, because they have the option to do so. And a certain proportion of DAF money may not ever get granted out at all.

As Roger Colinvau says, any gift to a DAF is, by definition, a postponement of the distribution of that gift to active charities. And, as we discussed earlier, postponement has opportunity costs. “True, a contribution received later might be larger due to investment gains,” Colinvau says, “but if the contribution was made in year one, the donee then could also have reaped those gains, and more importantly, would have had discretion about how best to use the funds, discretion that is deferred by the DAF intermediary.”<sup>75</sup>

Colinvau also makes a persuasive argument that the very nature of DAFs themselves may change a donor’s attitude towards charity. He writes:

*“Before the DAF, the donor might have made contributions to a variety of public charities in small amounts each year. But now that the donor’s annual giving may accumulate in a DAF, the donor starts to think about giving differently—less as making current contributions and more as saving for the future. For example, the donor might decide to accumulate assets in order to build up a*

*sufficient sum so as to advise distributions of just the income each year, or to involve the donor's children in grant-making. Such a shift in attitude toward giving likely is reinforced by the fact that many sponsoring organizations have relatively high contribution thresholds of several thousand dollars for initial gifts. For the donor, this reinforces the idea that money set aside in a DAF is more of an investment than a spending transaction.*"<sup>76</sup>

If donors begin seeing philanthropy as a self-serving investment, rather than as gifting for public benefit, it could undercut the effectiveness of DAF giving still further.

- **DAF grants do not have to go to active charities.**

The Giving Institute reported in its first report on donor-advised funds that from 2012 to 2015, 4.4% of all DAF grants went not to active charities, but to other DAFs.<sup>77</sup> And in 2016, the *Economist* magazine analyzed grants from the three largest DAFs at that time: Fidelity, Schwab, and Vanguard. "Many payments went to worthy causes such as Médecins Sans Frontières and the Red Cross," the *Economist* reported. "But it is notable that the biggest recipient of DAFs' gifts is none other than Fidelity. The third-biggest is the American Endowment Foundation, another DAF supplier."<sup>78</sup>

According to the *Economist*, the sponsors in question said that these DAF-to-DAF gifts were "an innocuous rejigging of personal finances." And giving from one DAF to another is within the letter of the law, since DAFs are, themselves, charities. But neither are these grants being deployed in the way the charitable deduction provision intends. And it means that DAF payout rates, particularly those for national sponsors, may be inflated by internal transactions that do not benefit direct charities at all.

## **Risks to DAF Donors**

When it comes to national sponsors that have partnerships with commercial financial services companies, there is at least one more party that may be losing out with DAFs: the donors themselves.

According to U.S. Trust's *Study of High Net Worth Philanthropy*, 24% of high-net worth donors consulted with at least one advisor before making their charitable gifts. One third of the time, that advice came from an accountant or a financial or wealth advisor.<sup>79</sup>

Even though the DAFs set up by for-profit firms are technically separate entities, they are still associated with their parent companies in ways that can influence the behavior of staff in both organizations. The concern is that if a donor's advisor works at a corporation that manages a donor-advised fund, the advisor's own financial interests, or those of the corporation, may lead them to push the donor towards DAF giving over direct giving to charity.

And if the donor is genuinely giving out of a desire to effect change for the good—as a great many surely are—following their advisor's advice could mean that their giving will have much less of an effect than they would like.

There are two main reasons why donors may not be getting entirely unbiased advice when it comes to DAF giving.

- **Financial advisors are often rewarded for steering their clients towards DAFs.**

In many corporations, staff members who refer their clients to the corporation's DAF receive bonuses for doing so. At Fidelity Investments, for example, advisors whose clients set up a donor-advised fund at Fidelity Charitable get a bonus of a quarter of a percent of the amount of assets in a donor's DAF each year.<sup>80</sup>

In these cases, Madoff and Cullman write, "When a client discusses charitable giving with his financial adviser, the adviser has every financial incentive to recommend that the client establish a DAF rather than make an outright gift to an operating charity."<sup>81</sup> Because of this, a philanthropically-inclined client may be convinced to set up a DAF without realizing that it may not be best for the charities they support, or for what they hope to accomplish with their giving.

- **Financial advisors, corporate fund managers, and DAF staff are rewarded for keeping money in DAFs once they are established.**

Once a fund is set up at a corporate-affiliated DAF, several parties have a vested interest in keeping those funds intact and growing.

As we saw above, a financial advisor who recommends a DAF to a client may receive continuing bonuses that are based on the amount of assets held in those funds.

Once a DAF is set up, the for-profit corporation affiliated with the DAF manages those assets. The donor-advised funds at Fidelity Charitable are managed by Fidelity Investments, for example, as the funds at Schwab Charitable are managed by Charles Schwab. And the corporation charges the fund a fee for this management—usually, again, based on the amount of assets held in the fund.

In addition, the staff of the donor-advised fund itself often receive salaries that are based on the size of the assets in the fund.<sup>82</sup>

All of these people have a stake in keeping money in the DAF. It would be natural for them, whether consciously or not, to lean towards encouraging donors to parcel out their donations in smaller amounts, over a longer time—leaving more in the fund to gain in value and to produce more in income for the corporation, the DAF, and their respective employees.

In other words, there is a mutually-beneficial symbiotic relationship between national sponsor donor-advised funds and the corporations that founded them that may be detrimental to getting money out to charities. The fund benefits from the customer base available to the corporation; the corporation benefits from managing the fund's assets; and both benefit from increased contributions and lower payouts. "Providers profit from having more assets under their management and invested in their own funds," writes the *Economist* magazine. "They therefore stand to gain from dissuading donors—who have already claimed their tax deductions—from making payments out of their DAF. And, because the money sitting in a DAF grows from the investment income, donors are further deterred from passing it on quickly to a good cause."<sup>83</sup>

## Not All DAFs Are Created Equal

It should be said that, for the most part, the risks we have described above apply primarily to national sponsoring organizations—particularly those spun off from commercial financial services enterprises.

The two other types of DAF sponsors—community foundations and single-issue organizations—have been channeling money into local and regional charities for years, reaping disproportionately little benefit back into their own institutions. And donating to a DAF at a community foundation or a single-issue organization is arguably more like donating to an active charity, since these sponsors are more closely connected to the specific causes, communities, and institutions they are dedicated to support. "When the DAF is part of a charity that has other goals," writes Roger Colinvaux, "as with a community foundation or single-issue charity, the DAF is not an end in itself but an

activity used in furtherance of those goals. As a general matter, donors to these DAF sponsors are attracted to the underlying mission of the sponsor, contributions are earmarked for a particular cause or charity, and the advice offered by donors should fit within the mission of the underlying charity.”<sup>84</sup>

National sponsoring organizations (NSOs) are different. They were not founded to address any specific charitable goal, such as furthering environmental protection, childhood development, or affordable housing. They were founded solely to manage and administer funds, in cooperation with their for-profit partner corporations. “The commercially sponsored NSO may formally be an independent organization,” says Colinvau, “but nevertheless it has an existential relationship with a for-profit investment firm, which precedes the charity in every case...Further, there is an inherent tension, if not a conflict of interest, between the mission of the NSO (to distribute funds) and the mission of the for-profit (to hold and invest funds).”<sup>85</sup>

And when fund management and fund growth become a higher priority for a DAF sponsor than granting money out to charities—the purpose for which DAFs were created and granted tax-deductible charitable status in the first place—the national sponsor looks less like a charity, and more like a bank.

For this reason, many of the policy changes we recommend below are inspired by, and apply mainly to, national sponsoring organizations. They have grown phenomenally in recent years, and have certainly given out a large amount of money in grants to nonprofits over that time. But their growth has been relatively unregulated and unmonitored, and it is reasonable to implement measures to ensure that it results in a positive outcome for taxpayers, charities, and donors.

## Recommendations and Policy Changes

The current rules surrounding DAFs are tipped to the advantage of donors and the financial industry at the expense of the public interest and the independent sector.

There is no shortage of ideas for how to provide proper oversight over DAFs and to protect public interests; the challenge is in making the case to decision makers that policy reforms are needed, and in decision makers’ willingness to implement them. The waters around DAFs are murky: sponsors have different motivations and behaviors; their granting behavior can be hard to track; and they straddle a fuzzy line between charities and private foundations. And many DAF sponsors, particularly those

associated with for-profit finance companies, have a vested interest in the status quo, and lobby hard to prevent restrictions on their operations.

But with their phenomenal growth in recent years, it is more important than ever to ensure that DAFs provide an adequate return to the taxpayers subsidizing them, that DAFs are not pulling an undue amount of philanthropic revenue away from active charities for personal gain, and that DAF donors are getting complete, unbiased advice when making their charitable decisions.

## **Recommendations to Ensure an Adequate Return to the Public**

As we have seen, donor-advised funds provide significant financial benefits to their donors through the tax deductibility of DAF donations. The taxpaying public underwrites the cost of each charitable deduction in exchange for an expected societal benefit from the donor's contribution.

The donor is able to take their tax deduction the moment they give their money to the DAF, but the public does not see any benefit from that money until it is granted to an active charity. This means that, in order to see the best return from their subsidy, it is in the public's interest to ensure that there is a relatively quick turnaround between deduction and grant. There are various possible ways of making this happen.

- **Require distribution of DAF donations within a fixed number of years.**

This may be the most direct and easily implemented measure we could take to ensure that DAF donations are granted out in a timely manner. Different lengths of time have been suggested for a maximum donation payout period: industry consultant Alan Cantor has recommended 15 years<sup>86</sup>; law professors and DAF experts Ray Madoff and Roger Colinvaux have recommended 10 years<sup>87</sup>; and a proposal submitted to Congress by former U.S. Representative Dave Camp recommended 5 years.<sup>88</sup>

There are also different ways of enforcing the payout at the end of the time period. Madoff and Colinvaux have proposed that the DAF donor would designate a "non-DAF charity" that would receive any funds that were not paid out by the end of the time limit.<sup>89</sup> Camp's proposal would have levied an excise tax on any assets held in DAFs after the end of the limit.<sup>90</sup>

Some DAF sponsors have been strongly resistant to any of these proposals, and have fought them vigorously. Madoff and Colinvaux's proposals have met with stiff opposition in public forums;<sup>91</sup> Camp's proposal was part of the 2014 tax bill debate but never reached the floor for a vote.<sup>92</sup>

However, as Colinvaux points out, the IRS has the right to monitor the tax-exempt status of charities with a "commensurate in scope test,"<sup>93</sup> which makes sure that any organization doing charitable work is using its financial resources to do that work at a level proportionate to the amount of money they take in.<sup>94</sup> If an organization is doing far less charitable work than they can afford to, then they risk losing their exempt status. If DAFs are delayed in granting out their funds, or not granting at all, they risk failing the commensurate in scope test. And, if that is the case, any of these proposals would provide them with significantly more motivation for speedier granting than exists now.

- **Delay donor tax deduction until the funds are paid out to active charity.**

The previous two proposals are designed to shorten the time between public cost and public benefit by allowing DAF donors to continue to take a tax deduction immediately upon donation, and then speeding up the later granting of that donation to active charities. This proposal takes the opposite tack: it would allow DAFs take as much time as they want to distribute money to charity, but would ensure that the public does not have to bear the cost of the donation's tax deductibility until those grants are made.

Roger Colinvaux, who suggested this possible approach, explains that it would "treat the sponsoring organization as a conduit or agent" for the donor's giving<sup>95</sup>—which is what DAFs were originally designed to be; they were not set up to be permanent holding companies for assets.

- **Force funds to pay out at a specified rate.**

As an alternative to setting a time limit—or in addition to it—lawmakers could set a minimum annual distribution rate for DAFs. In 2004, after a number of suspected fraudulent activities by both private foundations and donor-advised funds, the Senate Finance Committee came up with a set of proposals designed to curb charitable malpractice. One of those proposals was to implement an annual 5% payout requirement on DAFs, the same as that required of private foundations.<sup>96</sup>

## Recommendations to Ensure Distributions Go to Active Charities

- **Bar private foundation donations to DAFs.**

The reason a 5% minimum payout rule was enacted for foundations was to ensure that their funds were distributed to active charities in a timely way. However, DAFs represent a loophole for this rule, since foundation trustees can count grants to DAFs towards their payout requirement while still essentially maintaining control over the funds.

While not technically illegal, this practice circumvents the rationale for maintaining a 5% minimum payout rule. For this reason, Madoff and Colinvaux have proposed prohibiting private foundations from being able to count gifts to DAFs towards their payout requirement.<sup>97</sup> “The payout is intended to measure distributions to active charities, not to other investment funds,” write Madoff and Cullman. “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.”<sup>98</sup>

- **Prohibit DAFs from giving grants to private foundations.**

Donors can not only avoid tax-related restrictions by granting from private foundations to DAFs; they are able to get around other tax restrictions by granting *from* a DAF *to* private foundations as well. Donors can deduct a significantly higher percentage of their adjusted gross income for their gift when they give to a DAF than when they give to a private foundation.<sup>99</sup> If a donor wants to have a gift end up in their private foundation, but also wants to get around the deductibility cap, they can first give the gift to a DAF, take the maximum deduction, and then later direct the DAF to grant that money to their foundation.

Not only does this allow the donor to get around the deductibility cap for gifts to foundations, but it also means that a portion of DAF granting is going to foundations, rather than to active charities. For these reasons, in 2004, the Senate Finance Committee proposed disallowing grants from DAFs to private foundations.<sup>100</sup>

- **Require standardized reporting from DAFs about their granting behavior.**

In early 2018, the Giving USA Foundation published their first report on patterns in donor-advised fund granting. It was a two-year project involving a great deal of difficult, rigorous data compilation, hand-coding, and quality assurance. They encountered incomplete IRS forms, DAF grant data combined with other grant data from the same organization, forms that were unreadable by computers, and errors in the data.<sup>101</sup> For this reason alone, it would be helpful to demand standardized reporting on grant making from donor-advised funds.

There is also another, less innocent reason why it would be appropriate to have more transparent reporting on DAF granting. The *Economist* reported that DAFs “are frequently used to funnel money to political campaigns and lobby groups, rather than what most people would consider good causes.” As an example, the magazine wrote, “One study by Robert Brulle of Drexel University, in Philadelphia, tracked contributions to the anti-climate-change lobby in America. He found that in 2009 and 2010 about a quarter of its backing which could be traced came via the Donors Trust, a Virginia-based DAF supplier.”<sup>102</sup> Because there is no consistent reporting requirement for DAF grants, this type of politically-motivated granting is difficult to uncover.

In the same way that high-net-worth donors often demand reporting from the charities they support about how their donations are being used, so the taxpayer and the charitable sector have a right to demand consistent, clear reporting from donor-advised fund sponsors about where their grants are going. This could mean requiring DAFs to provide more than just the first page of their IRS form 990 Schedule 1; separating DAF grants from other types of grants in their reporting; and using a standardized, digitally-readable format when their tax forms are submitted.

## **Recommendations to Eliminate Conflicts of Interest**

As we discussed earlier, financial services corporations that sponsor DAFs have incentives in place that could motivate their staff—consciously or not—to try to increase the amount of money in the DAF. Fund management fees, DAF administrators’ salaries, and bonuses for account advisors who recommend the DAF to their clients are often based, at least in part, on the amount of assets held in the DAF. And this could spur financial advisors at these companies to encourage customers not only to set up DAF funds instead of giving directly to charity, but also to give out less in grants from those funds after they are set up.

Professional fundraiser Bruce Makous has been a vocal critic of these financial incentives. “What you have here is a sweetheart deal among brokers to steer assets into their own gift funds,” Makous told the *Chronicle of Philanthropy* in an interview in 2005. “Donors should have an option, and their adviser should give them a list of funds to choose from. At the very least, the donor's adviser should not be managing the same money before and after the gift is made.”<sup>103</sup>

Makous has suggested several possible ways to minimize the conflicts of interest that financial incentives create for corporate advisors of potential donors, two of which include:

- **Limit management fees for commercial advisors.**  
Rather than receiving a fee based on a percentage of the assets in the funds, advisers could be rewarded based on a flat fee structure, or one that is at least capped. This would reduce the potential for an advisor to be inclined to recommend DAF giving, or smaller grants from an existing DAF, simply because they would be financially rewarded for doing so.
- **Require that donor-advised funds cannot be managed by the same organization that handles the donors' personal assets.**  
This would prevent financial advisors from being motivated to push a donor towards DAF giving, rather than giving directly to active charities because they are reluctant to lose assets under management.

## Conclusion

Donor-advised funds have been skyrocketing in popularity at a pace unlikely to slow down anytime soon. Overall charitable giving as a proportion of income has not gone up in unison with this rise, meaning that a steadily increasing share of U.S. charitable dollars is shifting away from direct charity and pouring into DAFs each year. Without rule changes, funds will continue to accumulate in DAFs, and will continue to benefit donors and fund managers personally, without commensurate benefits accruing to the society that has subsidized their giving.

There are significant risks to warehousing wealth in large financial institutions at a time of extreme wealth inequality and undisputed public need for the services charities provide. It is imperative to correct the rules regulating these charitable vehicles to ensure the public good is justly served. Steps must be taken to represent and defend the interests of taxpayers, charities, and donors.

## Appendix

### DAF Payout Rate Calculations in Detail

The annual payout rate of a DAF is, in principle, the total dollars paid out in grants in a given year divided by the total dollars held in assets in that same year.

The numerator of that equation—the total dollars paid out in grants—is a relatively straightforward number to determine from IRS forms. The problem is that the denominator—the total dollars a DAF holds in assets—is much more difficult to pin down.

One reason for the difficulty is that, as industry consultant Alan Cantor explains, “There’s no consensus, first of all, on whether the assets number should be drawn from the start of the fiscal year or the end.”<sup>104</sup> This is a critical point. The total market value of the assets held by a DAF tends to be smaller at the beginning of the year than at the end of the year—because the assets held in a fund usually appreciate in value, and because donors usually put more money into the DAF over the course of a year. Calculating the payout rate using the assets in a fund at the *beginning* of the year results in *larger* payout rates than calculating the rate using the assets in the fund at the end of the year. Most DAFs use one of these two measures—assets either at the beginning or the end of the year—when computing their payout rates.

For many years, the National Philanthropic Trust used the end of the year when calculating payout rates for its annual report on DAFs. In 2014, however, the NPT changed its calculation to use the beginning of the year instead. Their stated reason for the change was that it more closely aligned their rates with the way that the Foundation Center calculates granting rates for private foundations.<sup>105</sup> But, as Cantor says, “the result, presto change-o, was an increase in reported industrywide annual distributions from about 15 percent to 20 percent.”<sup>106</sup>

The Internal Revenue Service and the *Chronicle of Philanthropy* both use a third way of computing the total dollars held in assets by DAFs: they use the total dollars held in assets at the end of the year, *plus* any grants made during that year.<sup>107,108</sup>

This method results in smaller payout rates than either of the previous two. But we would posit—as do the IRS, the *Chronicle*, and Cantor—that it is the most valid approach of the three, because it includes not only assets already existing in the fund, but also any additional assets that are donated and then granted during the year. Paul

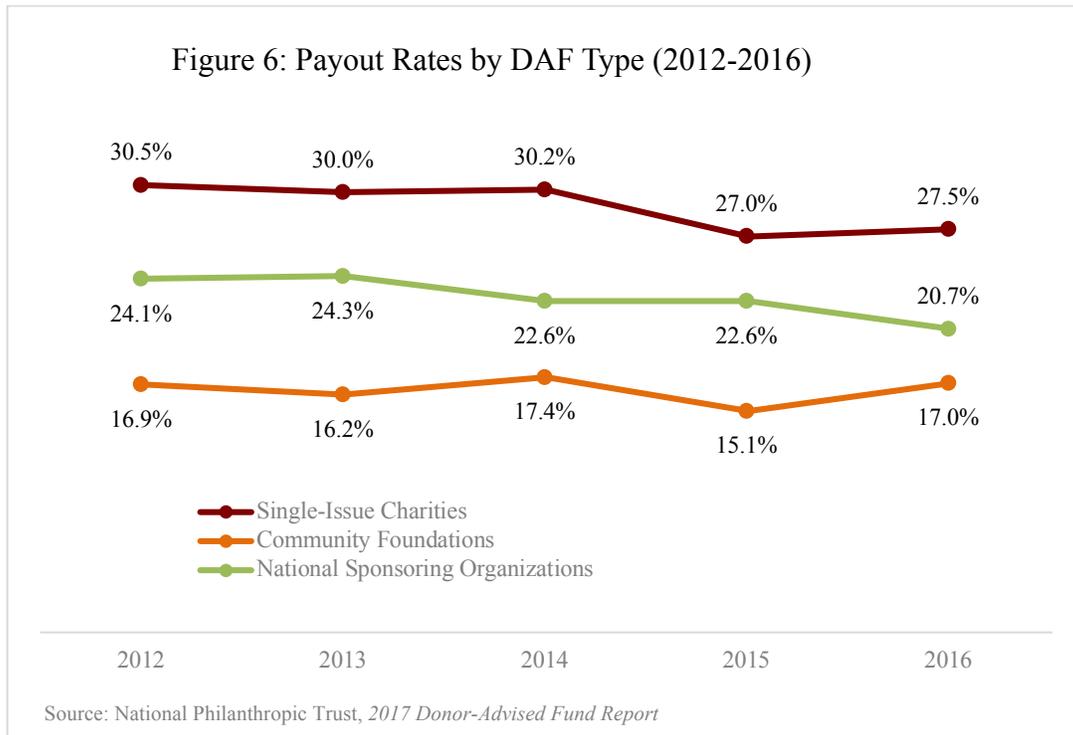
Arnsberger, the IRS statistician who originally developed the methodology, explains that this method provides “a more accurate picture of the value of funds each supporting organization had available to it over the course of the year.”<sup>109</sup>

### Payout Rates for Different Types of Sponsoring Organizations

Payout rates do vary quite a bit across the different types of sponsoring organizations, with single-issue sponsors tending to pay out at the highest rates, and national sponsors paying out at the lowest rates.

According to the National Philanthropic Trust, for example, the average payout rate for all U.S. DAFs was about 20% in 2016. But, digging deeper into this overall number, they reported that single-issue sponsors paid out at 27.5%, community foundations paid out at 17.0%, and national sponsors paid out at 20.7%.

In general, the payout rates for national sponsors and single-issue sponsors have both been declining over the past five years, while the rates for community foundations have been hovering consistently around 17% during that time.<sup>110</sup>



## Self-Reported Payout Rates for Fidelity and Schwab

Charitable foundations, single-issue sponsors, and most national sponsoring organizations tend to use one of the three methods described above when calculating their payout rates.

At least as of 2015, however, Fidelity Charitable Gift Fund and Schwab Charitable—the first and third largest national sponsors in the country, respectively—both used yet a fourth way of calculating their own payout rates. Their method is to divide the total amount of grants they pay out in one year by the average year-end value of the assets held in their funds over the most recent *five* years.<sup>111</sup>

As industry consultant Alan Cantor points out, because the assets in these national DAFs typically increase in value significantly every year, taking an average of the last five years considerably understates the amount that donors actually had available to grant in the most recent year.<sup>112</sup> The result is that Fidelity's and Schwab's self-reported payout rates are significantly higher than if they had used any of the three other methods of calculation above.

According to Fidelity's own calculations, for example, the payout rate for their funds overall in 2014 was 28%.<sup>113</sup> The *Chronicle of Philanthropy*, using the methodology developed by the IRS, calculated Fidelity's payout rate that year as 16%.<sup>114</sup>

### Using Averages in Payout Rate Calculations

Another concern that has been raised about payout rates, particularly for large national DAFs, is that reporting a single average rate for an entire sponsoring organization can mask a wide variation in rates across separate funds managed by that sponsor. While some individual funds in a DAF may have very high rates of payout, other funds managed by the same sponsor may pay out nothing at all. In 2012, for example, the IRS reported that roughly one fifth of all sponsoring organizations made no grants from their DAF accounts.<sup>115</sup>

This means that although a sponsoring organization may report a relatively high average payout rate overall, that can camouflage the fact that some of its funds may be paying out nothing. As Roger Colinvaux says, "High payouts by some funds mean that many funds held by the same sponsoring organization pay well below the mean...In other words, donors that distribute little to no money to charity from their DAFs would be able to free ride on the high payouts of other donors."<sup>116</sup>

## End Notes

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