Fixing What's Broken with Donor-Advised Funds:

Rewiring a Design Flaw that Encourages Warehousing of Charitable Assets

An IPS Inequality Briefing Paper

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The IPS Program on Inequality and the Common Good was founded in 2006 to draw attention to the growing dangers of concentrated wealth and power, and to advocate policies and practices to reverse extreme inequalities in income, wealth, and opportunity. The program has been investigating the intersection of inequality and race, taxation, philanthropy and the problem of hidden wealth.

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Summary

Donor-Advised Funds: A Broken System

At a time of unprecedented social and environmental challenges, wealthy individuals are using donor-advised funds, or DAFs, to claim substantial tax breaks, while often failing to move DAF revenue in a timely manner to working charities. An estimated $160 billion is currently warehoused in DAFs, and they are now the fastest-growing recipients of donations in the nonprofit sector.

Each year disproportionately more charitable revenue is diverted to these intermediaries while nonprofits on the ground struggle harder for funds. And, in the absence of adequate regulation and transparency, DAFs are ripe for abuse by donors and for-profit actors alike. This policy brief outlines the public interest in regulating DAFs, suggests solutions for doing so effectively, and provides estimates for the additional charitable revenue that would result from those solutions.

The Public Interest in Improved Regulation

Donors reap significant tax savings from DAF giving, and these savings are subsidized by the rest of American taxpayers through the charitable deduction and other tax reductions. The solutions proposed below are designed to ensure the public a commensurate return on this existing tax subsidy. In addition, nearly all of the solutions we propose below would incur no new revenue costs to the public; all changes in requirements for payout rates and distribution timelines are related to charitable deductions which have already been paid for by the U.S. taxpayer.

Policy Objectives

We believe there is a fundamental design flaw with DAFs which allows donors to reap immediate tax benefits but provides no incentive to fulfill the public interest by moving funds in a timely manner to active charities. The solutions outlined in this proposal are aimed at correcting this flaw and designed to do the following:

- Increase the flow of revenue from DAFs to working charities
- Discourage the warehousing of charitable revenue in DAFs
- Ensure transparency and public accountability
- Prevent abuses of the charitable system
- Protect the fairness and integrity of the tax system

Solutions

The policy recommendations outlined in this paper include solutions designed to improve DAF governance over the long term in three areas:

Solutions to Ensure an Adequate Return to the Public

- Require DAFs to pay out at a specified minimum annual rate
- Require distribution of DAF donations within a fixed number of years
- Delay tax deductions for DAF donations until the funds are distributed to working charities

Solutions to Ensure Distributions Go to Active Charities

- Bar DAF distributions to other DAFs from counting toward annual DAF payout
- Bar private foundation donations to DAFs from counting toward annual foundation payout
- Require greater transparency and standardized reporting from DAFs about their granting behavior

Solutions to Eliminate Conflicts of Interest

- Limit management fees for commercial advisors
- **R**equire that DAFs cannot be managed by the same organization that handles the donors' personal assets

Revenue Generated by Implementing a DAF Payout Requirement

Based on our research, mandating a 10 percent payout rate for donor-advised funds on a per-account basis would generate at least $3.5 billion, and potentially as much as $12.6 billion, in additional funds for charity each year.

Each of these topics is examined in more detail in the policy brief that follows.

Donor-Advised Funds: A Broken System

Warehousing Revenue Meant for the Public Benefit

An estimated $160 billion is warehoused in donor-advised funds, or DAFs, according to a November 2021 analysis. The donors to these funds have already taken substantial tax breaks for their contributions, but there are few incentives to move DAF revenue out to working charities on the ground. In fact, America's one million DAF accounts aren't legally required to pay out their funds at all; in a seminal 2012 study, the IRS reported that roughly one-fifth of all sponsoring organizations made no grants from their DAF accounts that year.

Sponsors themselves tout high aggregate payout rates for DAFs, usually in the range of 15 to 25 percent. But their self-reported DAF payout formulas are contentious. And these aggregate rates can mask a wide variation in rates in individual funds: while some accounts may have very high rates of payout, other funds managed by the same sponsor may pay out nothing at all.

For these reasons, a true picture of DAF payout rates has been frustratingly hard to come by. But a recent groundbreaking report from the Council of Michigan Foundations has given us a glimpse of reality: the Council examined grantmaking by community foundation DAFs in Michigan at the individual account level, and found that in 2018, their median payout rate was just 3.1%—far below the aggregate rates reported by most sponsors. The CMF also discovered that an average of 37 percent of Michigan's DAF accounts don't pay out any money to charity at all in any given year.

CMF was only able to analyze community foundations, and only those in Michigan. There is still no account-level reporting on community foundations in other states or on national commercial DAF sponsors such as Fidelity Charitable and Schwab Charitable, which typically have few rules requiring funds to give out grants from year to year, and which, in fact, have a considerable financial stake in donors leaving assets where they are.

Diverting Donations from Working Charities

Each year, disproportionately more and more charitable revenue is being diverted into DAFs while nonprofits on the ground struggle harder for funds. According to a recent analysis, the explosive growth of DAF giving has led to the diversion of $300 billion from working charities into intermediaries such as DAFs over the past five years alone.

As a result, DAFs are now the largest recipients of charitable giving in the United States. Until just a few years ago, the largest recipients of charitable giving in the US had always been direct charities such as the American Red Cross and the Salvation Army. Since 2016, however, the largest recipient of charitable giving in the US has been a commercial DAF sponsor: the Fidelity

Charitable Gift Fund. And in 2017, the *Chronicle of Philanthropy* reported that, for the first time, six of the ten top charities were DAFs.

Because of this trend, in 2018 the *Chronicle* stopped including DAFs in their list of top recipients of charitable donations, instead ranking only direct, "cause-related" charities. But that year, two DAF sponsors—Fidelity Charitable and Schwab Charitable—each received more private donations than the United Way, the *Chronicle*'s top cause-related charity. By 2020, DAF giving had grown to the point where donations to Fidelity Charitable were almost triple those received by the United Way, and almost six times those received by the Salvation Army.

Serving as a Mechanism for Potential Abuse

DAFs are ripe for abuse by donors and for-profit actors alike. First and foremost, as the *Chronicle of Philanthropy* has reported, 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. This can spur financial advisors 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.

There is also currently no way to track donations from individual DAF accounts. In fact, DAFs can be used to anonymize giving entirely through a simple loophole: if a donor directs a gift from a DAF at one sponsor to a DAF at another sponsor, they only need to put their lawyer's name on the grant as the adviser, not their own. Any subsequent grants from the second DAF account will then be untraceable back to the original donor, even to the IRS. This means that, unlike private foundations, DAFs can be used as sources of "dark money"—funding designed to promote specific public policy while the funders remain undisclosed. Donors are now funneling hundreds of millions anonymously through their DAFs to push agendas including climate change denial, the defunding of public schools, and the privatization of health care.

DAF donors are also currently able to take a tax deduction for the donation of complex non-cash assets such as artwork, antiquities, and real estate—assets which are notoriously difficult to appraise. It is significantly easier to make this type of donation to a DAF than to a private foundation, and the tax benefits are greater, since DAFs, as public foundations, are not subject to the same caps on donation deductibility. As the Treasury Department has revealed, this sort of property may be assessed at a significantly inflated value, allowing donors to claim a large deduction for something that may have cost them much less, or for which the actual sale value may turn out to be much lower.

And while DAFs were meant to be revolving funds moving revenue quickly out to charities, newly-popular impact investing strategies are jeopardizing the timely distribution of DAF assets. Donors are increasingly steering DAF holdings toward investments designed to have a positive societal impact—but some of these have little liquidity and can tie up assets for years. While it is certainly appropriate for individuals to invest their own assets in socially-responsible investments, it is an open question whether such a strategy should be applied to publicly subsidized, tax-advantaged vehicles such as DAFs, where assets should be readily convertible to grants. Our 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 will then be transferred in a timely way to charities working to promote a public good; donor-directed hobby investing through DAFs arguably breaks this social contract.

The Public Interest in Improved Regulation

Return on Existing Taxpayer Subsidies

Congress is justified in mandating increased DAF payout for the simple reason that donors reap significant tax savings from DAF giving, and these savings are subsidized by the rest of American taxpayers. Tax experts Roger Colinvaux and Ray Madoff have shown that this charitable subsidy can range from 37 to as much as 74 percent, depending on how much the donor's income, capital gains and estate taxes were reduced by the donation.

In addition, the wealthier the donor, the greater the public's tax subsidy of their donation is likely to be. Donors in the top 0.1 percent of income and asset holders are disproportionately more likely to donate appreciated non-cash assets to charities, and are most likely to donate stock that has a low or zero cost basis. These donations reduce not only their income taxes, but their capital gains taxes as well. And it appears that DAF donors are well aware of this advantage: Fidelity Charitable reported in 2020 that 68 percent of all DAF contributions that year had been made in the form of non-cash assets.

Colinvaux has additionally pointed out that the IRS has the right to monitor the tax-exempt status of charities with a "commensurate in scope" test, 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. If DAFs delay in granting out their funds, or do not grant at all, they would fail this test.

No New Revenue Costs

It is important to note that nearly all of the solutions we propose below would incur no new revenue costs to the public. Changes in requirements for payout rates and distribution timelines would all apply to charitable deductions which have already been paid for by the American taxpayer.

Policy objectives

The solutions outlined in this proposal are designed to do the following:

- **Increase the flow of revenue from donor-advised funds to working charities**. Our aim is to increase the movement of resources from donor-advised funds, which are intermediary funding institutions, to independent nonprofit organizations directly engaged in charitable work.

- **Discourage the warehousing of charitable revenue in DAFs.** DAF donors have already taken substantial tax breaks for their contributions, but there are few incentives and no legal requirement to move the money out to working charities. Some DAFs pay out in a timely way, but other accounts can languish for years.

- **Ensure public accountability** by improving reporting requirements for DAF contributions and grants. In the same way that donors often demand reporting from charities about how their donations are being used, the taxpayer has a right to demand consistent, clear reporting from DAF sponsors about where grants are going.

- **Prevent abuses** including conflicts of interest for financial advisers and the value inflation of donated complex non-cash assets.

Solutions

The measures below are divided into three types: solutions to ensure that DAFs provide an adequate return to the taxpayers subsidizing them; solutions to ensure that DAFs are not pulling an undue amount of philanthropic revenue away from active charities for personal gain; and solutions to ensure that DAF donors are getting complete, unbiased advice when making their charitable decisions. Please see our white paper *The Case for an Emergency Charity Stimulus* for a detailed discussion of all of these options.

Solutions to Ensure an Adequate Return to the Public

- **Require funds to pay out at a specified rate.** Private foundations are required to pay out 5 percent of their assets annually, but no payout requirement currently exists for DAFs. Lawmakers could set a minimum annual distribution rate for DAFs on a per-account basis, with an excise tax penalty levied on any individual accounts that do not meet the requirement, as is the case for foundations. We suggest an annual payout requirement of at least 10 percent. Payout rate would be calculated using the method applied by the Internal Revenue Service, using the aggregate DAF value at the end of the most recently completed year.

- **Require distribution of DAF donations within a fixed number of years.** This is the most direct and easily implemented way 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, typically between 5 and 15 years. And several options are available for enforcing the payout at the end of the time period, from excise taxes to the designation of a charity to automatically receive any undistributed funds at the end of a DAF lifespan.

- **Delay donor tax deductions for donor-advised funds donations until the funds are distributed to working charities.** This proposal would allow DAFs to 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. This solution would also ensure that donors would receive tax deductions for the actual sale value of complex non-cash assets such as artwork and real estate.

Solutions to Ensure Distributions Go to Active Charities

- **Bar DAF distributions to other DAFs from counting toward annual DAF payout.** Payout would include only distributions to organizations directly involved in charitable work.

- **Bar private foundation donations to DAFs from counting toward annual foundation payout.** Congress enacted a 5% minimum payout rule for foundations 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 foundations. And, as tax expert Ray Madoff and philanthropist Lewis B. Cullman have written, it allows charitable revenue to be transferred from charitable intermediaries with a high level of transparency to intermediaries with next to none.

- **Require greater transparency and standardized reporting from DAFs about their granting behavior.** In their research for a 2018 report on DAFs, the Giving USA Foundation encountered incomplete and unreadable tax forms, DAF data combined with non-DAF data, and errors. Improved reporting as suggested by the Giving USA Foundation would include requiring DAFs to provide more than just the first page of their IRS form 990 Schedule I; separating DAF grants from other types of grants in their reporting; and using a standardized, digitally-readable format when tax forms are submitted.

Solutions to Eliminate Conflicts of Interest

- **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 capped. This would reduce the potential for an advisor to recommend setting up a DAF, or giving out 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.

Revenue Generated by Implementing a DAF Payout Requirement

As we discussed earlier, the aggregate payout rates reported by DAF sponsors can mask a wide variation in rates across separate funds managed by that sponsor. And there is, unfortunately, no reliable nationwide data on the payout rates of individual DAF accounts. **But recent studies indicate that mandating a 10 percent payout rate for donor-advised funds on a per-account basis would generate at least $3.5 billion, and potentially as much as $12.6 billion, in additional funds for charity each year.**

Below we present two ways of projecting the revenue generated by a 10 percent per-account mandated payout rate. The first method covers the entire nation but uses older, more conservative IRS estimates of the proportion of DAF accounts that pay out nothing. The second method applies more recent, actual median payout rates from the Council of Michigan Foundation’s report on Michigan DAFs to the rest of the country.

Using IRS Estimates of Zero-Payout DAF Accounts

In one of the only rigorous, nationwide studies on DAF payout, the IRS reported that roughly one fifth of all sponsoring organizations made no grants whatsoever from their DAF accounts in 2012.

According to the IRS, the most accurate DAF payout rate is calculated as the total grants made from a DAF account divided by the sum of the assets held in the account at the end of the year plus the grants made from the DAF during the year. According to the National Philanthropic Trust’s most recent annual report on DAFs, there were more than one million individual DAF accounts in the U.S. in 2020, and the average size of each account was over $159,000. If the IRS’s 2012 findings hold true across DAFs generally, it would mean that 201,020 DAF accounts, one-fifth of the total, paid out nothing in 2020. If these non-paying accounts had instead been subject to a 10 percent minimum payout requirement, they each would have to pay out $17,669 in grants—for a total of over $3.5 billion in additional revenue going to working charities.

Estimated Additional Revenue to Charity Gained from a 10% Mandated Payout Rate for DAFs in 2020

Based on IRS Estimates of Zero-Payout DAF Accounts

DAF Assets at Year End	
Total DAF assets	$159,830,000,000
Number of DAF accounts in the United States	1,005,099
Average assets per DAF	$159,019
DAF Giving	
Estimated number of DAFs paying out nothing (one-fifth of total)	201,020
Average amount of required payout per DAF account at 10% minimum payout rate	$17,669
Additional revenue to charity gained from mandating 10% payout rate from non-paying DAFs ($17,669 additional revenue per non-paying DAF account x 201,020 non-paying DAF accounts)	**$3,551,777,778**

Estimates of DAF total assets, numbers, and average assets are from:
2021 NPT Report on Donor-Advised Funds (https://www.nptrust.org/reports/daf-report/)
Payout rate formula and estimated proportion of DAFs that paid nothing are from:
2012 analysis by IRS economist Paul Arnsberger, "Donor-Advised Funds: An Overview Using IRS Data," p. 61
(https://lawdigitalcommons.bc.edu/philanthropy-forum/donoradvised2015/papers/5/)

Using Payout Rates from the Council of Michigan Foundations Study

In a recent analysis, the Council of Michigan Foundations (CMF) found that in 2018, the median payout rate of Michigan's DAF accounts was just 3.1 percent. The CMF was only able to analyze Michigan community foundation DAFs; there is still no country-wide account-level reporting on community foundations in other states or on national commercial DAFs. As of now, therefore, the CMF report is the only current, reliable source for individual granting behavior for a good-sized sample of funds.

According to the IRS, the most accurate DAF payout rate is calculated as the total grants made from a DAF account divided by the sum of the assets held in the account at the end of the year plus the grants made from the DAF during the year. According to the National Philanthropic Trust's most recent annual report on DAFs, there were more than one million individual DAF accounts in the U.S. in 2020, and the average size of each account was over $159,000. If each of these accounts indeed paid out at Michigan's median 3.1 percent in 2020, it means that each of them paid out an average of just over $5,000 in grants to charity.

If a 10 percent minimum payout rate had been in place in 2020, it would have bumped those grants up to more than $12,500 per account—for a total of more than $12.6 billion in additional revenue flowing out to working charities.

Estimated Additional Revenue to Charity Gained from a 10% Mandated Payout Rate for DAFs in 2020

Based on an estimated actual payout rate of 3.1% (using CMF medians)

DAF Assets at Year End	
Total DAF assets	$159,830,000,000
Number of DAF accounts in the United States	1,005,099
Average assets per DAF	$159,019
DAF Giving	
Payout per DAF account at actual 3.1% rate (using CMF medians)	$5,087
Payout per DAF account at proposed 10.0% mandated minimum rate	$17,669
Difference in payout per DAF account between 10.0% and 3.1%	$12,581
Additional revenue to charity gained from mandating 10% payout rate	**$12,645,648,435**
($12,581 additional revenue per DAF account x 1,005,099 DAF accounts)	

Estimates of DAF total assets, numbers, and average assets are from:
2021 NPT Report on Donor-Advised Funds (https://www.nptrust.org/reports/daf-report/)
Estimated median payout of DAF accounts is from:
"Analysis of Donor Advised Funds from a Community Foundation Perspective" by the Council of Michigan Foundations
(https://www.michiganfoundations.org/resources/analysis-donor-advised-funds-community-foundation-perspective)
Payout rate formula is from:
2012 analysis by IRS economist Paul Arnsberger, "Donor-Advised Funds: An Overview Using IRS Data," p. 61
(https://lawdigitalcommons.bc.edu/philanthropy-forum/donoradvised2015/papers/5/)