Policy Proposals for Charitable Reform

Compiled by the Charity Reform Initiative of the Institute for Policy Studies

The Need for Charitable Reform

The last time Congress overhauled the legal framework for the philanthropic sector was in 1969, when wealth was considerably less concentrated than it is now. This framework provided important tax-reduction incentives to encourage timely giving to charity—but it also created the loophole that allowed for the commercial exploitation of donor-advised funds. It is time to modernize the rules governing philanthropy to:

- Promote a robust independent nonprofit sector outside of individual, political, and corporate influence.
- Prevent abuses of the tax system by philanthropy primarily used for aggressive tax avoidance or as a means to maintain control over donated dollars.
- Protect democracy and public society from the undue influence of private wealth and power.

[Like other aspects of society, philanthropy has not been immune from the impact of extreme inequality, concentrated wealth, and financialization of economy –along with capture of political system by wealthy]

To further these larger goals, the rules governing philanthropy should be overhauled to maximize the public good in these ways:

- Discourage the warehousing of charitable wealth by ensuring the timely flow of funds out of charitable giving vehicles for the public benefit.
- Implement governance mechanisms to align tax deductions with the public interest and to protect the integrity of our tax system.
- Encourage broad-based giving across all segments of society, particularly by the non-wealthy.

What follows is a menu of reforms, formed in consultation with policy experts in the philanthropic and civic space. We do not view our role as final arbiters of policy recommendations and, in some cases, offer multiple policy solutions.

Reforms to Discourage the Warehousing of Charitable Wealth

The reforms below would increase the flow of charitable dollars, ensure greater accountability, and curb abuse by the indirect giving vehicles of foundations and donor-advised funds.

A. Reforms to Donor-Advised Funds

The Tax Reform Act of 1969 largely established the rules governing public charities that we use today. But, as historian Lila Corwin Berman has written, the Act also opened giant loopholes that gave "unprecedented levels of public-subsidized power to private actors—specifically, to donor-advised funds." DAFs have taken advantage of these loopholes to set up private giving accounts with no payout requirement, few transparency and reporting provisions, and other abuses of the public trust.

The "donor-advised" descriptor is essentially a fictional notion, since the donor continues to control the destination of their gifts and, often, the investment practices of the fund. To protect the interests of the taxpaying public, Congress must address the fundamental design flaws in the DAF system with the reforms below.

> **A1. Require a payout for donor-advised funds.** DAFs should be required to pay out the entirety of any donations within three years after donations have gone into the fund, including any income earned on these original donations during that time. DAF sponsors would set up sub-accounts under each fund for each calendar year to track the payout schedule of donations and income by year.
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> A faster DAF payout would have broad public support. According to a recent Ipsos poll, a full half of Americans believe DAFs should pay out within 2 years, and 72 percent believe DAFs should pay out within 5 years.
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> **A2. Allow tax deductions to be taken only after the distribution of funds to an operating charity.** Currently, donors take their tax deductions when their donations go into the DAF, giving them no incentive to move funds out to working charities in a timely way. Distributions to another DAF or impact investment would not count as distributions to operating charities.
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> **A3. Limit tax deductions for donations of complex assets to their sale value.** This would base the deductions for donations of complex, non-cash appreciated property such as artwork, real estate, and cryptocurrency on their actual sale value, rather than their assessed value, and would delay that deduction until the year the property is sold. This would prevent donors from receiving charitable tax deductions based on overly-inflated assessments of the property's value.
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> **A4. Exclude impact investments from counting toward DAF payout.** Impact investing should be encouraged, but not through tax-advantaged intermediaries. DAFs are meant to be used as short-term intermediaries for transferring funds to charities. To ensure that these tax-deductible donations serve the public interest, revenue should not be tied up in the DAF for more than a short time. There are existing DAFs that have assets currently tied up in multi-year impact investments and are not able, in the short-term, to pay out funds. These DAFs could be temporarily exempted from the new rules.
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> **A5. Increase DAF transparency and reporting.** Donations to and from DAFs, as well as payout rates, should be publicly disclosed and reported on an account-by-account basis. To meet the IRS's public support test, which ensures that charitable organizations are broadly-supported, grants from donor-advised funds should also be attributed to the individual donor and not to the sponsoring organization. This could be done in such a way as to protect anonymous givers.

We would also suggest mandating that DAF sponsors disclose to the IRS the names of all individual donors who have contributed over $10,000 to each DAF account and the charities to which each individual DAF account has donated over $10,000.

A6. Prohibit perpetually-endowed donor-advised funds. Endowed DAFs are accounts where the income from the fund can be granted out to charity each year but the bulk—or sometimes all—of the principal must remain untouched. These endowed DAFs can currently be set up in perpetuity, and some states even offer tax credits to donors who do so.

But the deductibility of gifts to DAFs—which is entirely subsidized by the American public—is predicated on the use of those funds to serve the public interest in a timely way. Taxpayers should not be required to subsidize privately-controlled DAFs in perpetuity, since they receive no commensurate or timely benefit from perpetually-held funds.

A7. Set firmer requirements for the nonprofit status of sponsoring organizations. Some of those who know DAFs best have questioned whether sponsors should qualify as charities. For example, Marv Friedlander, who led the IRS division that approved DAFs as public charities in the first place, has written that "all in all, I think it's time to statutorily throw out the fiction that a DAF is a constituent part of a public charity."

This provision would make it so that DAF sponsors could not qualify as 501(c)(3) tax-exempt organizations if 25 percent or more of the sponsor's governing board are (a) dealers in securities, (b) officers of for-profit organizations, and/or (c) employees of a financial corporation that can exercise control over the sponsor.

If a sponsor cannot meet these conditions, then the DAFs they manage should not qualify as charitable. This would force DAF sponsors to draw an explicit distinction between their staff and the staff of any closely-affiliated corporations. And it would help to ensure that the sponsors' actions, recommendations, and reporting are driven solely by their charitable mission, rather than by for-profit interests.

B. Reforms to Private Foundations

Over the past few decades, the assets of private foundations have been piling up quickly. By the end of 2021, U.S. foundations had an estimated $1.3 trillion—money for which donors have already received tax deductions, but which is not making its way out to working charities. Foundations also have great latitude in what they can count as charitable distributions—including gifts to donor-advised funds and compensation paid to staff and board members—which opens up the risk of abuse and self-dealing.

B1. Increase the annual foundation payout requirement. Foundations currently only have to distribute a minimum of 5 percent of their asset value to charity each year. We propose increasing the requirement to 10 percent of assets.

An alternative to this would be to base the payout requirement on asset value, with the highest payout requirements for foundations with assets over $100 million. As Candid's Issue Lab has reported, smaller foundations typically have higher payout rates than larger foundations, so requiring larger foundations to pay out more would target the reform to where it is most needed.

Federal and state laws, including the Uniform Prudent Management of Institutional Funds Act, may need to be revised to allow for increased payout of charitable funds independent of economic conditions.

B2. Reform foundation payout exclusions. Fixes should include:

a) Eliminating administrative overhead from counting towards the minimum payout requirement. This would reduce incentives for exorbitant internal spending on salaries,

travel, and accommodations for board members; internal programs; and other administrative costs—and would move more funds to active charities.

b) Prohibiting grants to DAFs from qualifying toward the payout requirement unless the DAF funds are granted back out to working charities within one year. This mirrors a provision currently included in President Biden's 2023 budget proposal.

c) Closing loopholes that allow program-related and impact investments to be considered part of the payout allocation. Using tax-advantaged vehicles such as foundations for socially-oriented investing may have public benefits, but these activities undermine the principle of moving funds out of donor dominion in a timely way. In other words, no form of investment should be considered a charitable gift. Such activities can be continued, and even encouraged, but should not count toward the qualified payout distribution.

B3. Require board independence. If a private foundation is truly a public interest organization, it should not have a board composed entirely of family members and paid staff. Foundations should have independent boards with rules similar to those governing public corporation boards in many states.

B4. Impose a ban on compensating family members. To eliminate the potential for self-dealing, there should be an outright ban on compensation to founders and their family members for their services to the foundation.

B5. Disallow foundations from using mission-related impact investments (MRIs) to reduce their excise taxes. Private foundations can currently deduct the full amount of any MRI from their assets for the purpose of calculating their excise tax rate, thus allowing foundations to reduce their tax burden without giving out any additional revenue to working charities. [principal: only funds that leave dominion and control of donor are counted]

B6. Expand definitions of fiduciary duties to include mission alignment considerations. Foundations should have latitude in their investment policies and practices to exclude investments in socially injurious companies and enterprises that are not aligned with their missions.

B7. Eliminate the taxpayer-subsidized perpetual foundation. This would require the charters of all future private foundations to include a limited lifespan provision.

The idea that foundations should exist in perpetuity is in fundamental conflict with their tax-deductible status. The deductibility of gifts to foundations—which is entirely subsidized by the American public—is predicated on the use of those funds to serve the public interest in a timely way. Taxpayers should not be required to subsidize privately-controlled foundations in perpetuity, since they receive no commensurate or timely benefit from perpetually-held funds.

Alternatives to this would be to establish a higher excise tax rate on legacy foundations, or to create a Limited Lifespan Foundation status that is subject to a lower excise tax rate. Limited Lifespan Foundations would be chartered to exist for less than 25 years.

Reforms to Protect the Integrity of Our Tax System

Our system of charitable giving is a creature of the tax code, so we can't implement meaningful charity reform unless we close the loopholes that allow philanthropy to be used for tax avoidance. And reform will have little effect without proper oversight to ensure that donors follow the rules.

C. Creation of a New Oversight System for Foundations and Charities

The charitable nonprofit sector accounts for over 10 percent of America's private workforce and contributes 5 percent of the gross domestic product. But the offices of state attorneys general typically have small charity divisions with few resources devoted to oversight and are ill-equipped to oversee charities registered in their states. Concerns over the abuse of charities in the 1970s did spawn national watchdog entities like Independent Sector and the National Committee for Responsive Philanthropy, but broad-based public oversight of the sector is still severely lacking.

C1. Establish a Charity Reform Commision to set priorities for correcting the system. It is time for bold measures to fix philanthropy. As a first step, we recommend the formation of an independent Charity Reform Commission to review the menu of proposals set forth here. This Commission should include participants who understand the perils of the current direction of philanthropy and represent the wider public interest.

The Commission would enlist leaders within the philanthropic sector, but also draw from those concerned about democracy, the health of civil society, racial equity, economic inequality, and the integrity of the tax system and public sector investments. The Commission members should thoughtfully debate the various pathways to reform philanthropy. This assembly of the willing should avoid being paralyzed by defenders of the status quo: those benefiting significantly from tax-avoidance vehicles and self-interested legacy institutions that have historically blocked reform.

Based on the Commission's recommendations, advocates for charitable reform should then work with Congressional leaders to convene hearings and advance related legislation.

C2. Create a new Office of Charity Oversight. Policy makers could use excise tax revenue from foundations to fund a new independent watchdog organization, removing that responsibility from the IRS. This new regulatory body would have broad authority not only to support the nonprofit sector and increase its effectiveness, but also to hold it accountable.

The Department of the Treasury and the Internal Revenue Service are currently charged with certifying tax exemption and overseeing charitable giving. But they are also constrained in the resources allocated to enforcement, especially with severe cutbacks to the IRS, so larger-scale wrongdoing is slipping through the cracks as it is. "The wealthy are stealing tens of billions from American taxpayers," Senator Ron Wyden said recently about the inability of the IRS to enforce tax laws. "Paying taxes has become increasingly voluntary for those at the top." In the face of these large-scale challenges, investigating charitable abuses is a resource-intensive sideline with little revenue payoff.

This is particularly true when it comes to donor-advised funds. Marv Friedlander was the head of the IRS department that granted DAFs their charitable status in the first place. But he has lost patience with how IRS inattention has allowed DAFs to skirt the rules, and suggests that the time has come for them to be managed some other way. "Why impose technically dense provisions on IRS agents," he writes, "when DAFs…have failed to operate properly because they are not subject to the oversight of the funding public."

The good news is that the foundation sector provides substantial federal revenue itself with which to fund an oversight body. Revenue from the excise tax on the net investment income of foundations was $960.9 million in 2018, the most recent data available. At this stage, charities generate over $1 billion to fund an oversight body.

C3. Provide free online public access to nonprofit tax filings. The new Office of Charity Oversight should take over the IRS's existing authority and responsibility for the collection, standardization, and online hosting of charitable tax returns, and should continue to provide them at no charge to the public. Data transparency is essential to proper governance of the sector. Many interested parties, including the Nonprofit Open Data Collective, have fought to ensure that charitable tax filings are publicly accessible, and, in particular, that all private foundations file their

tax returns electronically so they can be more easily analyzed. But the IRS is overburdened and has had difficulty making this happen. Updates are slow, forms are often inconsistently filled-out, and entire schedules or attachments can go missing. We must have an oversight body that can provide free, reliable, complete, timely, online access to these tax filings.

C4. Provide block grants to state oversight offices. The new Office of Charity Oversight could allocate a portion of excise tax revenue to state-level oversight offices. Funds could be block-granted to states depending on the size of their philanthropic and charity sectors.

D. Reforms to Increase Transparency

Legislators can take action to restore public trust in the charitable giving sector after decades of opaque activities. This would include reducing the politicization of charities and increasing transparency into the dark money world of anonymous political contributions and antidemocratic influence.

D1. Prevent the politicization of charities. Ensure that Congress doesn't eliminate the Johnson Amendment, which currently prohibits charities from supporting or opposing candidates for public office.

D2. Disclose certain donors to and distributions from donor-advised funds. DAF sponsors should disclose to the IRS the names of individual donors who have contributed $10,000 or more to a DAF account, as well as the charities to which individual DAF accounts have donated $10,000 or more.

D3. Shine a light on dark money. Require the disclosure of donors to 501(c)4 corporations, which serve as a key mechanism for dark money donations from both the right and the left. While donors to 501(c)4 corporations don't claim a tax deduction, they can anonymously use them to give unlimited funds to influence issue work and campaigns. This disclosure could be limited to donors who have contributed $10,000 or more to a DAF account.

Reforms to Encourage Broad-Based Giving

Long-term declines in charitable giving by lower-dollar givers are less a result of tax policy and more a reflection of growing income inequality and declining economic security for many households. The only real way to broaden charitable support is to foster an economy that supports a stable and secure middle class, and to ensure that they have disposable income to donate to charity. For this reason, lawmakers should carefully structure policies to increase donor tax incentives so that they do not further subsidize households in the top 10 to 20 percent of income and assets. And they must balance private incentives for private charitable giving with the need for public revenues to support public services.

E. Reform to Broaden Giving

Everyday Americans give generously when they can. When economic times are better for everyone, charitable giving increases as a percentage of disposable income—showing that most people give more when they are able to do so. We should encourage this natural generosity and give nonprofits a broader, more diverse base of support, by providing taxpayers at all income levels with an incentive to give.

We can encourage giving at all income levels by establishing a charitable tax deduction that applies to all taxpayers, not just those that itemize deductions on their returns. The trick is to establish a deduction that will not only provide real incentives for people to give more to charity, but also cost less to implement than it brings in.

E1. Replace the itemized charitable deduction with a universal charitable tax deduction. We recommend implementing a universal tax deduction for any households—not just those that itemize—that give more than 2 percent of their adjusted gross income to charity.

As part of the CARES pandemic relief Act of 2020, Congress implemented a temporary above-the-line charitable tax deduction for non-itemizing households. The measure allowed a maximum deduction of $300 for individuals and $600 for married couples, and was extended through 2021. This provision cost a great deal and ended up doing very little to increase giving, mainly because most people who do donate already give more than $300 in any given year.

A recent study by the Tax Policy Center shows that a universal deduction for giving at least 2 percent of adjusted gross income, on the other hand, is a "sweet spot" that would increase charitable contributions while simultaneously increasing tax revenue as well. After analyzing 2019 tax revenues, they determined that such a deduction would have resulted in $2.1 billion more revenue going to charities, and $1.1 billion more revenue in taxes that year. Any sort of universal tax deduction should exclude gifts to private foundations and donor-advised funds—as was the case with the temporary 2020-2021 CARES Act tax deduction.

F. Reforms to Reverse Top-Heavy Philanthropy

Philanthropic reform alone is insufficient to remedy the antidemocratic effects of concentrated private wealth and power. For this, we need to tackle the broader ecosystem of wealth management practices of which strategic charitable giving is one aspect. The reforms below would directly address the problem of concentrated wealth and power in the charitable sector.

F1. Establish a lifetime cap on charitable gift deductions. Currently, we allow unlimited tax reductions to donors who have private foundations. This means that, as Bill Gates Sr. pointed out to report co-author Chuck Collins, Gates' son—Microsoft founder Bill Gates—will never pay taxes on the more than $100 billion he will donate to his tax-exempt foundation. A lifetime cap of $500 million would not discourage billionaires whose giving is genuinely motivated by generosity. But it would prevent donors from using charitable giving to reduce their taxes to zero indefinitely.

F2. Establish a cap on the charitable estate tax deduction. There is currently no limit on the amount of money that a person can pass tax-free to charity in their estate. This means that wealthy people can entirely remove themselves from the tax system by transferring their assets to their own private foundation. It is important that every person contribute to the costs of government—particularly the wealthiest among us. One way of accomplishing this would be by limiting the estate tax charitable deduction to a percentage of a donor's estate; we would recommend 50 percent.

F3. Treat gifts of appreciated assets as sales subject to capital gains taxes. Currently, donors can escape capital gains taxes by donating appreciated non-cash assets such as corporate stock, real estate, and artwork to charity. This is true not only for gifts to the more common 501(c)(3) public charities, but also for gifts to 501(c)(4) social welfare charities, which are allowed to engage in lobbying and political campaigning. The most straightforward way to curb this sort of tax avoidance would be to treat a gift of a non-cash asset to any charity as a sale, and to collect the appropriate capital gains tax on that gift from the donor.

F4. Levy a wealth tax on DAFs and closely-held private foundations. A wealth tax, such as Senator Elizabeth Warren's proposal to levy a 2 percent annual tax on wealth over $50 million, should also apply both to donor-advised funds and to private foundations that are closely controlled by donors. As Emmanuel Saez and Gabriel Zucman wrote in a 2019 paper on wealth taxation, "To prevent abuse, donor advised funds or funds in private foundations controlled by funders should be subject to the wealth tax until the time that such funds have been spent or moved fully out of the control of the donor." For example, assets in the Musk Foundation should be counted as part of Elon Musk's personal wealth until it moves out to working charities. This would encourage the transfer of charitable funds to nonprofits, public foundations, and community foundations' general funds that wealthy donors do not control.