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Charities and Taxpayers Deserve More From Donor-Advised Funds

By Ray D. Madoff

A stunning change has taken place in the top ranks of *The Chronicle'*s Philanthropy 400, one that requires all of us to face fundamental questions about whether the rules designed to encourage charitable giving are producing results that best serve American society.

This change is the extraordinary rise of donor-advised funds. For the first time, the American charity that raised the most donations is Fidelity Charitable, the biggest sponsor of donor-advised funds. In the past year, Fidelity raised $4.6 billion, far surpassing the previous leader, United Way Worldwide, which raised $3.7 billion.

DAF sponsors like Fidelity Charitable operate as middleman charities, holding donations and awaiting instructions from donors about where the funds should be spent. Fidelity Charitable is not alone. Many other DAF sponsors, including community foundations, also appear on the list of the 400 charities that attract the most from individuals, foundations, and corporations.

In less than a quarter of a century, we have seen a major transformation as universities, museums, hospitals, religious institutions, emergency-relief organizations, and other traditional nonprofits have been displaced by donor-advised-fund sponsors as top recipients of charitable dollars. This is particularly troubling since charitable contributions have consistently hovered around 2 percent of the U.S. gross domestic product. That means that the growth of DAF donations is coming at the cost of reduced outright donations to charities.

As donor-advised-fund sponsors are becoming America's biggest charitable entities, concerns about them become ever more consequential. Most troubling is that there is no evidence that the benefits from these funds are going to the public. Instead, most of the benefits appear to be going to America's richest people, biggest financial houses, and a host of investment advisers across the country.

Much of the conversation about DAFs has focused on whether they should be subject to distribution requirements. Today's law does not set any rules, even though donors get maximum tax benefits as soon as they make contributions.

The focus on distribution standards is important but obscures the larger concern that DAFs undermine fundamental principles of what it means to give. These principles permeate the tax code, particularly the changes that were added in the Tax Reform Act of 1969. At that time, Congress was concerned that tax benefits for charitable gifts provided too many benefits and too much control for donors and provided too little benefit to the public. That's why Congress adopted sweeping rules largely designed to encourage donors to steer money to organizations

that could put the money to use right away and to those that let the public, not the donor, have the greatest control over donated funds.

Congress was also concerned with ensuring greater transparency in the nonprofit world.

DAFs might hew to the letter of the law, but they do so at the expense of values that the law was written to fulfill.

It is easy for the average American to have missed the extraordinary transformation that has taken place, because DAF sponsors take many forms. The most jarring to the uninitiated are the charities formed by for-profit financial institutions. In addition to Fidelity Charitable, other big ones include Schwab Charitable and Vanguard Charitable — all organizations that rely heavily on their corporate founders to market the benefits of giving through DAFs to wealthy Americans.

Community foundations, which sponsored the earliest forms of DAFs, have experienced their own DAF explosion. The country's largest, the Silicon Valley Community Foundation, with more than $7 billion under management, is almost entirely DAF-driven. Jewish federations have long offered donor-advised funds, and in recent years other groups have been tapping the interest, like Rotary International and Cornell University. Even United Way, ousted from the top Philanthropy 400 list by Fidelity Charitable, has joined the ranks of nonprofits offering donor-advised funds.

It's a bit like *Invasion of the Body Snatchers* to see the victims of the donor-advised-fund boom turning around and offering them on their own.

What all of these organizations have in common is that they offer donors the ability to make what appear like outright donations to charity. Behind the scenes, what is happening, in essence, is that DAF sponsors make a side agreement with the donors to hold these funds and let the contributor have control over the money.

The dominance of DAFs is the direct result of the many benefits they offer to wealthy donors, their sponsors, and the financial-services industry.

The greatest beneficiaries are wealthy donors. Affluent people love DAFs because they make it easy to time their contributions to get the maximum tax benefit — without giving up any say over where the funds will go, and in many cases, how their assets are managed.

That's why some people call DAFs the "have your cake and eat it, too, charitable donation." Most important, the tax benefits donors receive from DAFs are far more substantial than if they had turned over the same contribution to a foundation, especially when it comes to donations of real estate, hedge-fund interests, and other complex assets. What's more, unlike private foundations, DAF funds are not subject to excise taxes, payout rules, or disclosure requirements.

The organizations that sponsor DAFs get benefits, too. Donor-advised fund sponsors get management fees based on how much money they hold; as the funds grow, so do the management fees. In addition, community foundations and other traditional charities find that

DAF accounts provide important access to donors and an opportunity to connect with donors about their work.

The financial-services industry also benefits. Financial institutions that have created their own DAFs are able to broaden their menu of services by offering clients a way to get the tax advantages of charitable giving without losing the profits from keeping these funds under management. The financial-services industry also benefits because donors' financial advisers continue to receive fees (now from the DAF sponsor) to manage DAF money.

Given this confluence of interests — along with the marketing powers of the financial-services industry — it is little wonder that DAFs have grown so quickly. Moreover, there is every reason to believe that this trajectory will continue.

But it would be a mistake to assume the growth of DAFs is good news for charity or society. Since federal law doesn't require DAF funds to ever be distributed, there's no way to be sure the money in them will ever flow to charities. Moreover, since Fidelity Charitable and other sponsors benefit financially by keeping the money in donor-advised funds under management, they have little reason to encourage donors to make speedy payouts to charity.

In response to these concerns, tax experts and others have proposed setting a time limit on how long donations can stay in the funds. In 2012, Rep. Dave Camp, who then headed the key Congressional tax committee, proposed that donor-advised funds be distributed within five years of contribution.

While such a requirement would do much to help charities, the focus on payout alone has obscured the larger policy concerns raised by DAFs. Here's how the rise of the donor-advised funds undermines fundamental values developed over 100 years of public policy on philanthropy:

They don't curtail donor control. A fundamental principle of tax law is that donors are not entitled to a deduction for charitable contributions unless the donor gives up complete "dominion and control" over donated funds. There is good reason for Congress to tie the deduction to donors giving up control to an organization that can put the money to active use. Society cannot benefit if donated funds are not in complete control of the nonprofit organizations holding them. Donor-advised funds give donors exactly what the tax law was designed to prevent: an immediate deduction for gifts with the donor keeping control over the money.

How do DAFs perform this magic?

Largely with a wink and a nod. When people give to donor-advised funds, they do so with the understanding that they will be able to direct charitable gifts from their DAFs. However, if the legal documents reflected this understanding, donors would not be eligible for the charitable deduction.

So legal agreements state that donors maintain no control over DAF funds; instead they say that these funds are solely subject to the control of DAF sponsors. But that's not how they work in

reality. Nobody would give millions of dollars to Fidelity Charitable with the idea that the Board of Trustees of Fidelity Charitable would decide where the money goes.

In this way, current DAFs are fundamentally different from the early forms offered by community foundations in the 1930s. At that time, DAFs were designed to help wealthy donors who wanted to benefit the community but who also wanted a voice in how their money would advance local causes. The voice was truly advisory (thus the name "donor-advised" funds), and contributors most certainly knew that the board ultimately controlled the donated funds.

Today the legal documents say "advice," but everyone understands it is direction. For most DAF sponsors, so long as long as the recommended transfer is charitable in nature, donors may direct their funds to whatever group they choose on whatever schedule they choose. That approach is explicitly inconsistent with fundamental principles of charitable tax law.

They don’t give donors incentives to send money to active causes. Congress also wanted to encourage the flow of dollars to organizations that do charity work themselves or that receive money from a broad range of people. That’s why donors to charities get better tax benefits than those who give to their own foundations, and why private operating foundations — which run their own charitable programs — receive greater benefits than regular foundations. It’s also why private foundations must distribute a minimum percentage of assets each year.

Even with all those rules, Congress failed to anticipate how donor-advised funds would find a way to get maximum tax benefits to donors without providing any assurances that those funds would ever get committed to active causes.

They don’t encourage transparency. Congress has enacted a slew of rules designed to make sure the public knows how direct donations, tax subsidies, and other privileges granted to charitable organizations are being used. Most notably, charities and foundations are required to provide significant information about their operations on their tax returns and are also required to make these tax returns available to the public. The goal is to enable people to decide for themselves whether charities are truly operating for the public good.

However, DAF sponsors undermine transparency by aggregating contributions and disbursements from all of their donor-advised funds into a single report. It is impossible for observers to determine the activities of any single donor-advised fund. This secrecy is particularly problematic in cases like the Leonardo DiCaprio Foundation, which bills itself as an environmental grant maker, saying it has awarded "over $30 million since 2010 to fund 78 high-impact projects in more than 44 countries."

However, any donor seeking to confirm these donations would be unable to do so, since all contributions are funneled through a donor-advised fund at the California Community Foundation. Since the California Community Foundation reports its grant making on an aggregate basis, it is impossible to know what, if anything, is done with the money raised by the Leonardo DiCaprio Foundation.

This is not an isolated instance. Other people are using donor-advised funds to serve essentially as pop-up charities that provide tax benefits to donors and offer little transparency.

DAFs are here to stay — but that doesn't mean that lawmakers, nonprofit leaders, and the public need to keep letting them undermine the philanthropic spirit that is the very bedrock of our democracy.

Congress should pass legislation that sets out clear values about what these charitable savings accounts must do in return for the subsidy Americans give them through the tax code. In doing so, Congress should recognize the importance of transparency and getting donated funds out of donors' hands and into the control of charities that can put those dollars to work to improve our world today.

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