DONOR-ADVISED FUNDS AND THE SHIFTING CHARITABLE LANDSCAPE: WHY CONGRESS MUST RESPOND

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Abstract: In recent years, donor-advised funds (DAFs), historically a relatively minor part of American philanthropy, have taken on an outsized importance. The dramatic growth of donor-advised funds has been driven not only by the inherent attractiveness of DAFs, but also by the profit margins of the financial services industry and the donors' financial advisors. As more and more money rushes into DAFs – as of 2013, roughly 7% of all charitable gifts from individuals – the operating nonprofits that supposedly are the beneficiaries of donor-advised funds are losing out. At a time of higher demand for services and reduced funding, nonprofits are looking to individual donors for financial support, but increasingly donors are diverting their gifts into DAFs. This might be acceptable if DAFs were inspiring increased charitable giving, but there is little evidence to support that claim. And, because there is no mandated spend-down requirement, far more money is flowing into donor-advised funds than is flowing out into the charitable community. Wise public policy demands that Congress act to mandate an account-by-account spend-down of donor-advised funds within 15 to 20 years of the date of donation, and to prohibit private foundations from meeting their 5% distribution requirement through grants to DAFs.

Philanthropy is no longer primarily defined by the donation of money to charity. Though the majority of American donors continue to give contributions directly to schools, soup kitchens, Boys and Girls Clubs, and other nonprofits, increasingly donors prefer to squirrel charitable funds into philanthropic entities that they control. Only later, if at all, does the money finally reach operating nonprofits providing actual services. While the traditional vehicle for this kind of deferred giving, the private foundation, continues to receive significant new donations every year, the increasingly popular choice in recent years has been the donor-advised fund. Donor-advised funds (DAFs) are naturally attractive to donors, offering tremendous – and, I would argue, too much – flexibility. But the success of donor-advised funds is not simply based on their inherent qualities. The driving force behind the rise of donor-advised funds is the financial services industry, which has found a simple and marketable way to profit from charitable

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giving. Meanwhile, nonprofit organizations that provide actual services are losing out. Money that otherwise would have gone to the nonprofits as direct donations is now being diverted into donor-advised funds.

DAFs have experienced astronomical growth. Giving to donor-advised funds in 2013 was more than two-and-a-half times the level of only four years before,[1] and contributions to donor-advised funds exceeded 7% of total giving from individuals.[2] Advocates for donor-advised funds see this surging popularity as an unalloyed good, promoting charitable giving among those who otherwise would not be donors, and making philanthropy simpler and more flexible for a wider swath of people. They also see donor-advised funds as promoting the democratization of philanthropy, allowing upper-middle-class donors who could never afford to establish private foundations to create philanthropic vehicles of their own.

Others of us are vastly more skeptical. Donor-advised funds have grown like kudzu, but there's no evidence that DAFs are increasing overall charitable giving. In fact, there are indications that money that otherwise would have gone to operating charities – the organizations that are doing the actual work of the sector – is now streaming into donor-advised funds. Moreover, it now seems clear that the engine driving the growth in donor-advised funds has not been the dawning of a new kind of charitable impulse, but the profit margins of the financial services industry. Over the past twenty-five years, Wall Street has established itself as an invasive species in the charitable ecosystem, fundamentally altering incentives, motivations, rewards, and relationships. Charitable giving has changed, and not for the better.

THE EVOLUTION OF DONOR-ADVISED FUNDS

Donor-advised funds are not new. The first were created in the 1930s at the New York Community Trust, and other community foundations followed suit. Before that time, community foundations like the New York Community Trust had relied primarily upon charitable bequests to build their assets. The foundations' leaders saw donor-advised funds as a way to engage living donors and promote lifetime giving.

The notion behind DAFs was both attractive and a bit self-contradictory, presaging the ambiguity that hovers around donor-advised

[1] "2014 Donor-Advised Fund Report," National Philanthropic Trust, http://www.nptrust.org/daf-report/recent-growth.html, accessed July 14, 2015.

[2] This figure is derived by dividing the total contributed to donor-advised funds in 2013, $17.28 billion, according to the 2014 Donor-Advised Fund Report of the National Philanthropic Trust, into the total donated by living individuals, $240.6 billion, according to the 2014 Giving USA™ report on 2013.

funds today. A gift to a community foundation establishing a donor-advised fund was considered an outright donation, with control of the funds passing fully to the community foundation and its board. This structure provided the donor with an immediate full charitable deduction. Yet there was an understanding that donors retained an ongoing privilege to direct where and when those funds would be eventually distributed. The architects of DAFs were careful not to call these entities "donor-*directed* funds," as that would have indicated a legal right to exert control (as opposed to an understanding of the parties), thereby negating the charitable deduction. And yet the donor's explicit influence in the decision-making was baked into the structure. From the beginning, there has been what some have called a "wink-and-nod" flavor to how donor-advised funds have been treated in tax law: the contribution to a donor-advised fund is an outright gift without any strings so far as the charitable tax deduction is concerned, but the donor retains significant influence over the distribution of the grants from the fund.

Over the years this ambiguity didn't bother many people, or even gain much attention, perhaps because not all that much money was involved. For decades, donor-advised funds resided mostly in the relatively obscure confines of community foundations, with several national religious federations joining in to create donor-advised programs of their own. That said, the number of community foundations mushroomed in the 1970s, 1980s, and 1990s, and donor-advised funds served as a major driver of that growth. The new community foundations did not have the large asset base of the older community foundations, and they needed to attract donors with an irresistible kind of offering. Donor-advised funds filled the bill. Donor-advised funds became the flagship product for community foundations new and old – a have-your-cake-and-eat-it-too way for donors to get a full charitable deduction at an advantageous moment, while retaining effective control of the assets after the gift was complete.

In the early years, there typically was a genuine sharing of responsibility for donor-advised fund grantmaking. Community foundations and their donors would talk with one another about grantmaking from the funds, nudging each other toward the best possible use of the grants. Community foundations remain in touch with their donors today, of course, but by many accounts there was a greater sense of shared decision-making before the 1990s, and the grant decisions were not nearly so exclusively the prerogative of the donor. A staff member of the New York Community Trust told me that in the 1980s there was discussion on the staff level about whether they even needed to send donors a year-end report on their donor-advised funds. The sense then, far more than now, was that donor advice was just that. The funds belonged to the donor-advised fund sponsor – that is, the community foundation.

But a sea change in the world of donor-advised funds came in 1991, when the IRS granted 501(c)(3) public charity tax status to the Fidelity Charitable Gift Fund. Donor-advised funds were no longer the exclusive province of community foundations and religious federations. Now donor-advised funds were integrated with a mutual fund powerhouse, complete with Wall Street's marketing power, technological expertise, and efficiencies of scale. The volume of money moving into donor-advised funds grew vastly larger, and the nature of donor-advised fund marketing and operations quickly transitioned to a model that bore little resemblance to the world before 1991.

The effect of Wall Street's arrival in the donor-advised fund industry was dramatic. Donor-advised funds became a commodity, compared on the basis of cost and efficiency, with little regard for the niceties of collaboration and consultation between sponsor and donor that characterized their early community foundation years. Donor-advised funds were reduced in large part to transactional entities. One click and the donor could establish a fund. A second click and the donor could choose the investment vehicles. The donor clicked a third time to make a grant. Fidelity did not ever pretend to provide in-depth advice to its donors on their grantmaking, nor did it make an effort to provide any sort of check on donors' decision-making, other than to ensure that the beneficiary was in fact a public charity. Fidelity (and, soon, Schwab and Vanguard and dozens of other commercial funds) left the grantmaking to the donors and kept the costs competitive. The original rationale for donor-advised funds – that this was a mission-driven partnership between the donor and the sponsoring organization, with the sponsoring organization providing philanthropic guidance and expertise – fell by the wayside in the rush for volume, efficiency, and market share.

Financial Incentives and the Growth of Donor-Advised Funds

The key to understanding the growth of donor-advised funds is to recognize the incentives donor-advised funds provide for the financial services industry. Compensation for financial advisors is typically based on the size of the assets they have under management: the larger their clients' portfolios, the higher the financial advisors' income. This gives financial advisors an incentive to keep their clients' money invested – and, of course, to manage those investments so that the portfolios grow. This also means that the clients' transfer of assets out of their accounts – to charities or any other purpose – results in a loss of income to the financial advisor.

A generation ago, charitable giving from a brokerage account was relatively simple. When a client decided to transfer significant assets as a gift to charity, the financial advisor might have grimaced inwardly. That's because assets would be flowing out of the client's portfolio, and the financial advisor's income would drop accordingly. That said, the financial advisor would have carried out his duty to the client and transferred the assets – usually in the form of appreciated stock – to the designated charity. The financial advisor really had no choice.

Today, the financial advisor has an alternative to offer the clients: the transfer of assets to a commercial donor-advised fund. The financial advisor typically will explain how the client can get a full charitable deduction for a gift to a donor-advised fund, as well as avoid all capital gains taxes on appreciated assets. The financial advisor will cite the flexibility of the DAF: the client can distribute grants now, or later, or build the fund up to serve as a philanthropic vehicle for future years or even for the next generation's philanthropic giving. What the financial advisor likely does *not* stress in that conversation (or, I imagine, even mention) is how the financial advisor will continue to draw management fees from the donor-advised fund, much as if the donor had never given the funds away at all. In fact, the longer the fund sits and grows, rather than being distributed to charity, the more the financial advisor will earn.

And as for the financial services firm itself? Though the donor-advised fund sponsoring organization is structured as an independent 501(c)(3) public charity, the donor-advised fund assets are typically invested in the affiliated for-profit corporation's mutual funds. This obviously is a source of profit for the corporation. Fidelity Charitable, for example, had more than $13 billion in assets at the close of its June 2013 tax year, an amount that clearly provides considerable income for Fidelity Investments.[3] Moreover, the charitable arm shares the name of the corporation ("Fidelity Charitable" or "The UBS Donor-Advised Fund"), thereby providing cross-marketing opportunities for the corporation and lending the firm a patina of charitable benevolence.

The growth in giving to donor-advised funds has been stunning. In the *Chronicle of Philanthropy's* 2014 "Philanthropy 400," its annual listing of the American nonprofits that raised the most money in the past year, three of the top ten organizations were commercial donor-advised funds (Fidelity Charitable at number two, Schwab Charitable at number four, and Vanguard Charitable at number ten), while a fourth donor-advised fund sponsor (the Silicon Valley Community Foundation) landed at number eight. (It's worth noting that none of these organizations existed in its current form 25 years before.) To provide some perspective, Stanford (number 14), Harvard (20), and Yale (39), all undeniable fundraising powerhouses, lagged far behind.

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[3] Fidelity Charitable 2014 Annual Report, http://fidelitycharitable.org/2014-annual-report/statements-activity.shtml, accessed July 3, 2015.

Overall giving to donor-advised funds in 2013 totaled $17.2 billion: 252% of the level of only four years before.[4]

Commercial donor-advised fund websites feature prominent marketing to financial advisors, with the persistent theme that it's very much in the self-interest of the financial advisors to encourage their clients to create donor-advised funds. As a video aimed at financial advisors on the Fidelity Charitable website puts it, "Charitable conversations help you grow your practice" and allow advisors "to reach new clients, including the next generation." The video emphasizes that financial advisors will be paid a fee for the investment management of their clients' donor-advised funds at Fidelity, and the voiceover reassures the financial advisors that when their clients create funds at Fidelity Charitable, they can report them as assets under management.[5]

Fidelity, Schwab, and Vanguard Charitable market both to the general public and to financial advisors at various firms. Though they are the largest and best known of the commercial gift funds, they are hardly alone. Dozens of financial services companies have their own in-house donor-advised funds and do not need to go out of their way to market to their own financial advisors. These financial advisors know full well that their clients' donor-advised funds count as assets under management. That is, the financial advisors understand that they will continue to draw income from their clients' donor-advised funds.

There is even one donor-advised fund entity, the American Endowment Foundation (number 152 on the 2014 Philanthropy 400), whose business model allows financial advisors to invest their clients' assets in financial instruments at nearly *any* firm. The founder of the American Endowment Foundation, Philip Tobin, had earlier served as the CFO of the Cleveland Foundation, the country's oldest community foundation. He saw that financial advisors were loath to encourage clients to set up funds at the Cleveland Foundation because they had no personal financial incentive to do so. Tobin realized that winning over financial advisors was the key to receiving DAF donations, and so he created an entity that is as user-friendly as possible for the financial services industry. Financial advisors can invest their

[4] National Philanthropic Trust, "2014 Donor-Advised Fund Report," http://www.nptrust.org/daf-report/recent-growth.html, accessed June 29, 2015.

[5] Fidelity Charitable, "Grow Your Practice With Our Charitable Investor Program," (video), available at http://fidelitycharitable.org/giving-strategies/videos/video21.shtml, accessed July 1, 2015.

clients' American Endowment Foundation donor-advised fund assets in nearly any financial instrument and receive management fees.[6]

Community foundations, which traditionally had not offered an incentive to financial advisors, have been at a competitive disadvantage, and they are now hustling to catch up. It is not as though giving to donor-advised funds at community foundations has been dormant, but community foundations have not seen growth as dramatic as at the commercial gift funds like Fidelity and Schwab.[7] In an effort to fight fire with fire, a growing number of community foundations are now cutting deals with financial advisors, allowing them to manage the assets of community foundation donor-advised funds created by their clients. This outreach illustrates how the traditional relationship between donor and nonprofit has changed. There is now a third party deeply involved in the charitable process: the donor's financial advisor, whose financial interest is at odds with that of the charitable sector as a whole.

What about operating nonprofits, the organizations that provide charitable services? They have largely been left behind. Yes, nonprofits receive grants from donor-advised funds, but year after year much more money has been going into donor-advised funds than has been going out in grants. (In 2013 the overall surplus was over $7 billion.) Moreover, donor-advised funds now serve as a middleman between nonprofits and many of the donors, complicating that critical relationship. Nonprofits also face logistical challenges, in that there are limitations on the purposes to which donor-advised fund grants can be used.[8] But, though nonprofit executives may complain vociferously in private, they say little or nothing publicly about donor-advised funds. This is not surprising: nonprofits are not in a position where they can risk offending their donors and funders.

No moment so captures the growing dominance in the charitable world of Wall Street values and incentives as the decision in 2014 by the Association of Fundraising Professionals (AFP), the preeminent national association of the nonprofit development field, to give the organization's highest honor to the President and CEO of the National Philanthropic Trust (NPT). The National Philanthropic Trust is a DAF sponsor that also functions as a back shop for commercial donor-advised funds at various financial firms. One client of NPT, for example, is the large financial services firm UBS. If

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[6] Author's interview with Tom Tobin, CEO of American Endowment Foundation, August 2013.

[7] National Philanthropic Trust, "2014 Donor-Advised Fund Report: Comparison by Sponsor Types," http://www.nptrust.org/daf-report/sponsor-type-comparison.html, accessed June 29, 2015.

[8] Alan Cantor, "Strings on Donor-Advised Funds Are Making Charity Supporters Angry," *Chronicle of Philanthropy*, August 12, 2015.

a client at UBS transfers assets to what is marketed as the UBS Donor-Advised Fund, in fact the money goes to the National Philanthropic Trust, which then manages the grantmaking and the reporting on behalf of UBS. As explained above, the driver for the growth of the UBS donor-advised fund and other commercial gift funds is the management fee paid to the clients' financial advisors. It is therefore not a stretch to say that the success of the National Philanthropic Trust (which ranked 26th in the most recent Philanthropy 400 survey) is based on financial incentives paid to the donors' financial advisors.

And this is precisely what made AFP's award to the National Philanthropic Trust CEO so telling – and so inappropriate. The Association of Fundraising Professionals' Code of Ethical Standards states that no solicitor of charitable gifts should receive a commission or be paid as a percentage of the gift. Rather, AFP asserts, all development staff should be salaried, to avoid conflicts of interest and the temptation to encourage gifts that would not be in the best interest of the donors and the nonprofits. And yet AFP gave its highest award to the CEO of an enterprise whose business model is based on precisely the kind of commissions that AFP itself deems unethical. If commercial donor-advised fund sponsors like NPT are indeed charitable institutions (as their application to the IRS assures us they are), that makes the financial advisors who promote gifts to the commercial gift funds charitable solicitors. And the subsequent management fee they receive (and continue to receive) is a very thinly veiled form of commission.

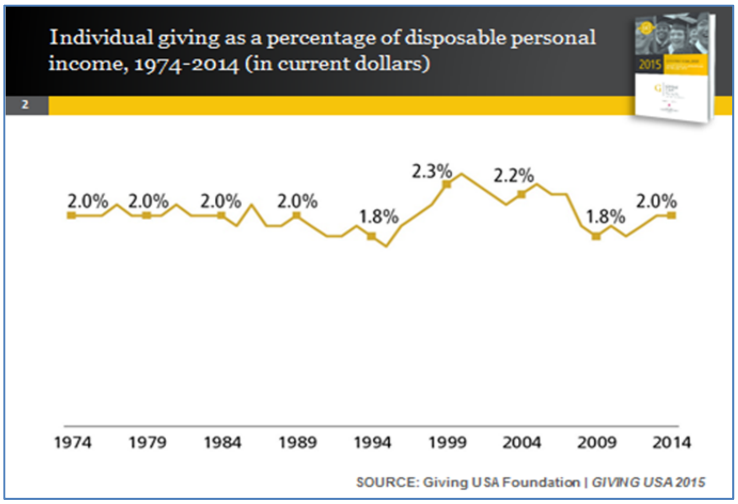
It's now clear the decision by the IRS in 1991 to offer public charity status to the Fidelity Charitable Gift Fund was an epochal moment, having a similar effect on the charitable world that the Supreme Court's *Citizens United* ruling had on politics. The 1991 Fidelity decision opened the floodgates to a rush of money associated with less-than-purely-charitable motivations. American philanthropy has changed in such a fundamental and sudden manner that even the country's major association of professional fundraisers is blinded to the ethical challenges presented by the rise of donor-advised funds.

MORE MONEY OR WAREHOUSED MONEY?

Advocates for donor-advised funds assert that DAFs are encouraging people who otherwise would not be so inclined to make charitable gifts, thereby increasing overall charitable giving. But the evidence for this is unconvincing.

With the tremendous growth in giving to donor-advised funds in recent years, we would expect to have seen a rise in the overall level of charitable giving. Certainly, charitable giving has been growing since the depths of the

Great Recession. But, as a percentage of disposable personal income, giving has remained flat. In fact, as Giving USA™ reports (Graph 1), charitable giving as a percentage of disposable personal income has remained virtually unchanged for the last 40 years, hovering at or around 2%. So the overall charitable giving as a percentage of disposable income has been flat, while the percentage of that giving that has been directed into donor-advised funds has been rising tremendously. This indicates that the portion of charitable giving going directly to operating charities has dropped. Money that might have gone to a community program or food pantry instead is going into donor-advised funds.



Advocates for donor-advised funds say that this argument misses the point. After all, they assert, money given to donor-advised funds eventually finds its way to operating charities. But does it? Those who seek reform of the rules governing donor-advised funds cite the absence of a required payout as the great flaw in this presumption. The IRS treats the donation of money to donor-advised funds as the charitable event, an outright gift to a 501(c)(3) public charity. There is no expectation that any particular fund then needs to distribute its assets in any year, or at all. The money in, say, the Espinoza Family Donor-Advised Fund can sit invested in perpetuity. In some cases the DAF sponsor (the community foundation or commercial gift fund) may contact the donor-advisors and suggest or even require that they make a distribution, but there is no federal requirement that a particular fund make charitable grants. Moreover, it would be naive to ignore the fact that, from a business standpoint, it's in the interest of the DAF sponsor for the donor-advised fund assets to remain invested. After all, the larger the donor-advised fund, and the longer it is invested, the more the DAF sponsor receives in fees – and, in the case of the commercial gift funds, the more the individual donors' financial advisors and the associated financial services firms earn in management fees.

Advocates for donor-advised funds take offense at the suggestion that the money is being warehoused, and they point to the high annual payout rate, which by their calculation hovers around 21%.[9] They note that this ratio is significantly higher than the 5% required (or the nearly 6% actually distributed) from private foundations.

Those who seek reform of the rules governing donor-advised funds counter that the comparison to private foundations is irrelevant. Donor-advised funds bring much greater tax benefits than private foundations, particularly in providing a market rate charitable tax deduction for appreciated privately-held stock, real estate, and other illiquid assets. (For gifts to private foundations, the charitable contribution for appreciated assets other than publicly traded stock is figured at the lower cost basis.) This amounts to an enormous subsidy by the federal government, and donor-advised funds consequently need to be held to a high standard in terms of their charitable impact. More to the point, gifts to donor-advised funds receive the same charitable deduction as contributions to operating nonprofits that are providing direct services. Shouldn't there be an expectation that a gift treated identically to a donation to an operating nonprofit actually goes out the door at some point to create some mission impact?

Second, averages can be deceiving. This was explained well in a 2012 study on donor-advised funds by the Congressional Research Service. The study pointed out that if there are ten identical donor-advised funds, and two put out 80% of their assets in a given year, and the other eight do not

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[9] In its 2014 Donor-Advised Fund Report, the National Philanthropic Trust (NPT) adjusted its formula for measuring the distribution rate from donor-advised funds. The distribution rate is essentially a ratio of funds granted out divided by assets under management. Before 2014, NPT used the *year-end* assets of all donor-advised funds as the denominator in figuring out the distribution ratio. For example, for calculating the spending rate in 2012, NPT took all the DAF grants in 2012 and divided that number by the total assets held by DAFs on December 31, 2012. This changed the next year. In calculating the distributions in 2013 (for its 2014 report), NPT began using the *start-of-year* assets as the denominator. That is, NPT divided the 2013 distributions by the December 31, 2012 asset total. This change served to increase the reported distribution percentage by 500 basis points or so, from about 16% to about 21%. (NPT also went back and adjusted the formula for earlier years, so the distribution percentages before 2013 bumped up retroactively in a similar way.) NPT felt the original formula somewhat underestimated distributions, because donors could make large contributions to their DAF accounts at year-end that would have gone into the asset total, but that would not have had time to be distributed. NPT has a point. That said, the new formula somewhat *overestimates* distributions. By their new calculations, when a dollar is donated *and* distributed in the year in question, it would result in only the *distribution* being counted, and not the assets (because the money would be gone by December 31). A fair estimation of the true distribution rate is probably somewhere between the results arrived at by these two methods – that is, somewhere between 16% and 21%.

distribute a single penny, then on average they have distributed 16%.[10] At first glance the 16% payout is impressive, but it's striking that this average distribution level could be reached when eight out of ten donors in this scenario did not distribute any grants at all.

Which leads to a third point: it is important to differentiate between charitable distributions from individual donor-advised fund accounts and the overall distributions from the donor-advised fund sponsors. In the wake of criticism about insufficient charitable distributions, DAF sponsors have taken to focusing their public relations on the charitable impact of their funds. They talk about their high overall distribution rates and cite the dollars they have distributed. ("Grants from Fidelity Charitable Donor-advised Funds Increased 33 Percent to Nearly $1.5 Billion, in First Half of 2015," read the headline from a recent press release, which is typical of the industry.[11]) In fact, Fidelity Charitable has gone so far as to create a contrived formula of its own for reporting – and exaggerating – its distributions, a calculation that divides that year's charitable distributions by the artificially low five-year trailing average of its total assets.[12]

Yet the same donor-advised fund leaders who speak about the primacy of charitable distributions are utterly resistant to the idea of requiring any sort of distributions on a per-account basis. Fidelity Charitable volunteered to hold itself to an *overall* minimum distribution of five percent annually (based, again, in their unique formulation, on fiscal year distributions divided by a five-year trailing average), a payout hurdle that is so much below its actual annual distribution that it seems designed purely for show. Meanwhile, Fidelity Charitable requires only that an individual account holder recommend total distributions of at least $250 over a seven-year period – hardly an intensive requirement, and such a tiny fraction of the average donor-advised fund that it barely registers as a percentage of the assets.[13]

Why does it matter how much each individual account holder distributes to charity? Because that person has received a full charitable tax deduction for the gift to the donor-advised fund, the same as a contribution to a soup kitchen that feeds the hungry. Common sense and smart public policy

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[10] Molly F. Sherlock and Jane G. Gravelle, Cong. Research Serv., R42595, "An Analysis of Charitable Giving and Donor Advised Funds" at 9 (June 11, 2012).

[11] Press Release, Fidelity Charitable, July 15, 2015, http://fidelitycharitable.org/about-us/news/07-15-2015.shtml.

[12] Alan M. Cantor, "A Closer Look at a Donor-Advised Fund's Questionable Payout Numbers," *Inside Philanthropy*, July 20, 2015. http://www.insidephilanthropy.com/home/2015/7/20/a-closer-look-at-a-donor-advised-funds-questionable-payout-n.html, accessed August 8, 2015.

[13] "Fidelity Charitable Policy Guidelines: Program Circular," at 18-19. http://www.fidelitycharitable.org/docs/Giving-Account-Policy-Guidelines.pdf, last updated Jul. 2013.

demand that charitable contributions actually go to a charitable purpose – if not immediately, then before too long.

Those supporting the *status quo* will respond by saying that the focus on per-account distributions misses the point. They assert that inactive funds are the exception, not the rule, and they point to the seemingly high overall annual distribution rate. But because of the lack of transparency surrounding donor-advised funds, the public has no way of knowing how many donor-advised funds are actually inactive or what the median – as opposed to the average – distribution rate might be. While the records of private foundations are open to the public, with each and every grant and honorarium revealed on their tax returns, donor-advised funds are considered part of a public charity – the DAF sponsor. Consequently, donor-advised fund sponsors do not have to share any grant information. That information remains private. Once money goes into a DAF, there's no way for anyone on the outside to be sure of the distribution of the assets.

At this point, the debate about donor-advised funds follows a predictable path. Critics accuse donor-advised funds of warehousing money and say that many funds are inactive. Donor-advised fund sponsors say that that's not the case – that very few funds are inactive. Critics respond by asking the DAF sponsors to share their account-by-account records so they can examine the evidence. The donor-advised fund sponsors respond by saying that they don't have to share that information, that they need to give their donors privacy, and that the public can and should trust them that the money is going out the door. And so the argument cycles around once more.

Manipulations of the System

Nearly all donors who create DAFs do so with good intentions. Though I may take issue with the rules under which donor-advised funds operate, I acknowledge that most donors are driven by charitable intent. But some donors have taken advantage of the murkiness and lack of transparency surrounding donor-advised funds for questionable ends.

This is certainly the case with private foundations using DAFs to meet their required payouts. Private foundations must distribute an amount equal to five percent of their assets annually, and all of their grants must be listed in the foundations' 990-PF tax returns. One ploy used by private foundations, either to obfuscate the identity of their grant recipients, to keep the funds in reserve for future grants, or as a safety valve in case they are struggling to meet the five-percent minimum distribution mark, is to make grants to donor-advised funds controlled by the foundations' trustees. Because the DAF sponsor meets the technical definition of a public charity, the foundation can include that grant to help it meet the five-percent distribution requirement. But though this tactic meets the letter of the law, it very much violates the spirit. The funds have not gone to an actual charitable purpose, but simply moved from one invested charitable fund to another. And though the foundation has given up legal control over the funds, it retains *de facto* control. In the process, transparency has been lost. Once the money has passed into the donor-advised fund, the public cannot ascertain the end-use charitable beneficiaries, or know if the funds had been distributed to operating charities at all. The trail runs cold.

In some cases, a grant to a donor-advised fund is a last-minute solution to meeting the five-percent distribution requirement. At other times a private foundation's use of donor-advised funds is a way of covering its trail and avoiding public scrutiny. One donor-advised fund sponsor that has been implicated in this sort of "identity laundering" has been the Virginia-based Donors Trust, which has passed over $400 million to conservative causes since 1999.[14]

To understand how Donors Trust operates, it's important to appreciate the advantages of having public charity tax status. A private foundation is required to report fully in its 990-PF tax returns each and every grant, investment, and honorarium. A public charity, by contrast, can offer its donors anonymity. Donor-advised fund sponsors, including Donors Trust, are considered public charities, and they consequently do not have to list their grants or say which DAF funded them. A report from the Center for Public Integrity detailed how some donors have taken advantage of the public charity status of Donors Trust to hide their foundation grants from disclosure. Prominent donors, including Charles Koch, have made large contributions to Donors Trust, often from their private foundations. Donors Trust then passed the money through as anonymous grants to controversial organizations such as the Heartland Institute, which works to debunk climate change research, and the American Legislative Exchange Council, which writes and facilitates conservative legislation at the state level.

There are two benefits to the donors and the nonprofits in this transaction. First, the donors are not directly connected to these organizations, as the grants are anonymous. This allows both the donors and the nonprofits to disavow any connection. Second, those grants are considered as coming from the public (because Donors Trust is a public charity with more than 200 donors), and that helps the nonprofit beneficiaries meet the "public support test." (The public support test is an arcane but critically important

[14] U.S. Senator Sheldon Whitehouse (Dem-RI) referred to this process as "an identity-laundering scheme." See Sandy Bauers, "Climate-change Skepticism's Funding Sources are Obscure" Philly.com, February 12, 2014, http://articles.philly.com/2014-02-12/news/47238883_1_richard-lindzen-brulle-global-warming.

measure to make sure that a particular public charity is not relying on only one or two major donors. An organization must prove that it has widespread contributions and earnings from many sources – "public support" – in order to keep its public charity tax status.) The use of donor-advised funds allows an organization to meet the public support test even in cases where nearly all of its income derives from a single individual. In other words, if one particular donor pays for 90% of an organization's operating expenses directly, the organization will be a private foundation, with all of the resulting disclosure requirements and less favorable tax treatment. However, if the same donor passes his or her contribution through a donor-advised fund, the recipient organization can now meet the definition of a public charity, with all the benefits that brings.[15]

Again, this sort of charitable shell game is likely the exception, not the rule. Most donors set up and utilize their donor-advised funds with honorable intentions. But the lack of transparency and regulation surrounding donor-advised funds serve as an invitation to manipulative behaviors by those who are so inclined.

Should Congress Respond? If so, how?

I do not advocate shutting down donor-advised funds. Donor-advised funds perform an important role in American philanthropy. Generally speaking, DAFs are more efficient than private foundations, and they are a user-friendly tool for donors, facilitating tax-efficient charitable giving. Donor-advised funds are particularly useful for harvesting capital gains at the time of a "liquidity event" such as the sale of a privately-held business. Should DAFs remain a part of the philanthropic landscape? Absolutely. Do they need to be reviewed and reformed in order to reduce abuses and increase their charitable impact? Again, absolutely. The rules governing donor-advised funds need to catch up with the realities of how they are currently being used.

One simple reform would be to prohibit private foundations from making grants to donor-advised funds. Private foundation grants to DAFs bypass the intent of the five-percent distribution rule, and granting money to donor-advised funds obfuscates the public's right to know where the private foundations' money is going. Singling out donor-advised funds as ineligible grantees makes public policy sense.

The more essential adjustment to the rules governing donor-advised funds would be to require the distribution of their assets to operating chari-

[15] Paul Abowd, "Donors use charity to push free-market policies in states," *The Center For Public Integrity*, February 14, 2013. See also Andy Kroll, "Exposed: The Dark-Money ATM of the Conservative Movement," *Mother Jones*, Feb. 5, 2013.

ties within a set period of years. A per-account spend-down requirement would help justify the charitable deduction by ensuring that money donated to donor-advised funds would actually find its way to charity, with the charitable impact happening before too much time has passed.

The idea of a required spend-down was first proposed in a 2011 *New York Times* op-ed by Boston College Law Professor Ray D. Madoff.[16] Madoff called for a seven-year spend-down for donor-advised funds. This concept received heightened attention in 2014 when Congressman Dave Camp (R-Mich.), then Chair of the House Ways and Means Committee, called for a *five*-year spend-down on donor-advised funds as part of his tax reform proposal. Both the Madoff and Camp proposals aimed at flushing the money held by donor-advised funds into the charitable community.

Is a five- or seven-year spend-down requirement the perfect time period for donor-advised funds? Perhaps not – but a per-account spend-down requirement of some sort makes perfect sense. At this point more and more money is going into donor-advised funds, where it can sit indefinitely, and it is in the financial interest of donor-advised fund sponsors and of financial advisors (where they are involved) to encourage only a minimal distribution. This is at odds with the needs of the community and the intent of Congress in creating the charitable deduction.

A reasonable alternative would be to require the spend-down of donor-advised fund assets within 15 or 20 years of the time the money is donated. Moreover, a rule could be put in place requiring each donor to name a non-DAF charitable beneficiary (or set of beneficiaries) to receive any undistributed funds at the end of the designated period. This structure would retain the flexibility and attractiveness of donor-advised funds (the donor, after all, would still have 15 or 20 years to make the distributions), while ensuring that the public's needs are met through distribution of the assets within a reasonable period of time. This would eliminate the opportunity to use the DAF as a perpetual entity, which would undoubtedly make some donors unhappy. But if donors are insistent upon creating a perpetual, intergenerational fund, they still have the option of creating a private foundation (albeit with less advantageous tax rules).

I recognize that this proposal would require DAF sponsors to adjust their business model. Without a doubt there would be a scramble to come up with software for tracking the distribution of assets. Sponsors would also need guidance on how to account for capital appreciation within the funds. Finally, it's likely that DAF sponsors would need to increase their fees, giv-

[16] Ray D. Madoff, "Tax Write-off Now, Charity Later," *The New York Times*, November 21, 2011.

en that the pace of grantmaking would be more vigorous and that the funds would be invested for a shorter duration. All of this said, the inconvenience to the sponsors would be more than compensated by the increased charitable impact of their grantmaking. We need to remind ourselves that the charitable deduction was not put in place to make life easier for a particular set of charitable institutions (in this case, the DAF sponsors), but to improve the condition of our nation. The quicker distribution of assets to charitable purposes would accomplish just that.

One caveat: We need to differentiate between creating a required spend-down for donor-advised funds – that is, paying the assets out within a certain number of years – and instituting an annual distribution requirement, such as the five-percent annual distribution rate required of foundations. An annual distribution rate for donor-advised funds, unless set at a very high level, would do more harm than good. A five-percent annual spending requirement for DAFs, which some have suggested, would cement in place the notion that donor-advised funds can and should be perpetual. It would also likely reduce the actual spending rate, which was what happened with foundations when the five-percent rule came into existence in 1969. (After 1969, the minimum payout of five percent became the *de facto* maximum for most foundations, including some that had previously been making grants at a higher rate.) Moreover, requiring small annual distributions would limit the flexibility of donor-advised funds, particularly their ability to make occasional-but-significant grants to major projects.

So to be clear, I am advocating a term-certain spend-down requirement. I am generally opposed to an annual distribution requirement.

The Pressure on Nonprofits

The need to reform donor-advised funds is driven by the recognition that the nonprofit sector provides vital services to the country, that funds in the hands of nonprofits result in social good, and that nonprofits are under enormous financial and programmatic pressure. For the seventh year in a row, a majority of nonprofits reported an increased demand for services.[17] Government funding for nonprofits, which in recent decades has underwritten about one-third of their operating expenses, continues to be cut at the federal, state, and local levels. Corporate giving has shrunk dramatically as a percentage of pre-tax profits,[18] and an increasing percentage of corporate giving is tied closely to the marketing of particular products, making funding inaccessible to many nonprofits.

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[17] ," Nonprofit Finance Fund, "2015 State of the Sector http://nonprofitfinancefund.org/state-of-the-sector-surveys, accessed July 3, 2015.

[18] Giving USA™ 2015 Report.

The largest single source of donations for nonprofits – 72 percent – is giving from living individuals.[19] When there is a disruption in the flow of donations from individuals, as the evidence suggests is happening because of donor-advised funds, there are compelling reasons to undertake reform. The work of nonprofits is too important, and the pressures on the sector too intense, to look the other way.

A Sense of Perspective, and a Resolution to Work Together

People in the philanthropic sector know about donor-advised funds, and many have strong feelings about how DAFs operate. Some are pushing for reform, while others are offering a full-throated defense of the *status quo*. Many have a personal stake in this debate, a connection that cannot help but influence their opinions. Given the emotions and vested interests involved in this question, perhaps it would be useful to draw back and consider how donor-advised funds as currently operated appear to people with a more objective perspective.

Imagine that you try to explain to the average person that dozens of Wall Street firms have created affiliated nonprofit donor-advised fund sponsoring organizations. Describe how the money in those DAFs is generally invested in the commercial firms' mutual funds, and that the donors' financial advisors draw a management fee, making more money over time if the funds are relatively inactive. Explain that the money never needs to go to charity and, by federal law, can remain invested indefinitely. And point out that the donors received the same charitable deduction at the time they established their funds as someone who had given directly to a homeless shelter.

I ask those who are adamantly defending the donor-advised fund *status quo* to consider how DAFs look from the outside. Yes, we can understand how donor-advised funds evolved over the last 80 years to arrive at the place where they are now. Certainly, we appreciate how donor-advised funds facilitate charitable giving, and we know many donors who are managing their funds responsibly and with great commitment. But, particularly since the deep involvement of the financial services industry, donor-advised funds simply don't look right, and that's because they *aren't* right. Donor-advised funds as currently structured are not deserving of the same charitable deduction as an operating public charity.

Reform is coming. Rather than denying that inevitability, and rather than marginalizing and vilifying those proposing reform of the current rules, leaders in the donor-advised fund industry should acknowledge common

[19] Giving USA™ 2015 Report.

ground and join in developing DAF reforms that will accomplish three goals: maximizing distributions to charity, providing donors with an appropriate degree of flexibility, and closing loopholes that allow private foundations to circumvent the five-percent distribution rule through grants to donor-advised funds. When all is said and done, those suggesting reform of donor-advised funds are simply asserting that charitable impact should remain the central driver of philanthropy. This is hardly revolutionary, and it's certainly not un-American. Reform of donor-advised funds is right, necessary, and long overdue.