OPINION

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5 Myths About Payout Rules for Donor-Advised Funds

By Ray Madoff

Donor-advised funds are in the process of taking over the charitable landscape.

While giving to most charities has remained largely flat in recent years, contributions to donor-advised funds are growing at eye-popping double-digit rates. At this pace, Fidelity Charitable, the biggest of the advised funds, will soon surpass United Way Worldwide and become the largest "charity" in the country.

What this explosion means for the nonprofit world is the subject of growing debate.

Supporters say that all is good: The funds have democratized philanthropy, making it easy for anyone—even those with just a small amount of money—to create an endowment that can be available with a click of the mouse whenever the urge to give strikes.

Others are far less sanguine about this shift in philanthropic giving. I and many other critics of the laws governing the funds are concerned that donors and the people who manage their money have been the primary recipients of benefits from the growth of donor-advised funds, while charities and the people they serve are being starved of resources.

Donors get an immediate up-front tax benefit—money that drains the federal treasury of much-needed revenue for government services—but face no obligations to ensure that the money makes its way out to charities in a timely manner. Under the law, these funds can be kept in place in perpetuity.

Adding to the problem is that private foundations can meet their 5-percent payout rule simply by transferring money to donor-advised funds rather than giving to real charities.

It is time to put policies in place to ensure that charities and those who depend on them get the benefit Congress intended when it created the charitable deduction.

As the debates about advised funds grow more intense, it's worth looking closely at five of the myths that their proponents like to advance when anyone suggests that it's time to require the funds to distribute a minimum sum, and to examine what's wrong with their arguments.

Donor-advised funds have increased overall charitable giving. Supporters like to suggest that the availability of donor-advised funds has spurred more charitable giving. Fidelity Charitable proclaims in its promotional materials that in the two decades since it was created, overall giving well outpaced inflation, rising by 72 percent—and suggests that donor-advised funds are responsible for that purported growth. But no one seriously thinks that inflation is the appropriate yardstick to use.

Rather, numbers from "Giving USA" show that charitable giving has not grown at all when compared with more appropriate economic indicators. For the past 40 years, overall charitable giving has remained at or about 2 percent of gross domestic product, and contributions from individuals have consistently hovered at 2 percent of disposable personal income.

Moreover, given the anemic growth in donations to the vast majority of charities in the past year, particularly in relation to the record-breaking year in the stock market, it's more likely that the rise in popularity of the advised funds has resulted in fewer—not more—resources for American charities.

Advised funds do not need payout rules because they already give a higher percentage of their assets than private foundations. The latest figures show that the organizations that offer donor-advised funds distribute on average 16 percent each year. Supporters of the status quo argue that this is much higher than for private foundations that often treat their requirement to distribute at least 5 percent of assets a year as the maximum they must give, not just the floor that Congress intended.

But these overall figures are extremely misleading. They are based on sponsoring organizations as a whole and not on each advised fund.

This aggregate approach can hide a lot of ills. The Congressional Research Service pointed out that a group that sponsors many donor-advised funds can achieve a 16-percent payout rate if only 20 percent of its accounts (measured by asset value) distribute an average of 80 percent of their funds each year, even if all of the remaining accounts distribute nothing at all.

Anecdotally, it appears that many small donors use advised funds to simplify their recordkeeping, and those donors distribute close to 100 percent each year. That's great, but that should not provide a license for other donors to warehouse their contributions in perpetuity.

But there's another more fundamental problem with this argument: Why compare advised funds with foundations?

Donors who put their money into advised funds receive many more tax benefits than those who give to foundations, most important among them the ability to write off the full value of appreciated real estate, artworks, closely held stock, and other nonmarketable assets. These generous tax breaks are a big reason for the astronomical growth of advised funds and all the more reason to impose some requirement on donors to give the money to benefit society in a timely manner.

Donor-advised funds do not need payout rules because they are no different from endowments. Some argue that it is unfair to complain about donor-advised funds since they are no worse then endowments at public charities, which have no payout obligations.

However, the reason current law allows endowments to let charities decide for themselves how to finance their missions. If an organization believes that creating a fund for hard times or spending frugally now better supports its charitable mission over the long haul, then we defer to its judgment.

This same justification does not extend to people who contribute to advised funds, nor should it. Donor-advised funds don't have a charitable purpose; they are simply a holding pen where people can put money before deciding where to give. If a donor wants to create a perpetual endowment for a particular cause, she can always do so within an existing charity or by creating a foundation.

Payout concerns do not apply to community foundations. Community foundations bristle when they are considered to be in the same category as commercial organizations that offer advised funds. They argue that the community foundations don't need payout rules because they want their donors to make distributions, unlike commercial funds that largely want fees for managing the money in an advised fund.

But community foundations actually appear to have worse payout rates than commercial funds. In the latest report from the National Philanthropic Trust, the annual payout from advised funds at community foundations was only 13.2 percent compared with the 15.1-percent overall payout rate from commercial funds.

To be sure, these aggregate numbers don't show everything that is really happening. And it is possible that donors who create funds at community foundations make more regular distributions than their commercial counterparts.

That said, this misses the more important point: If community foundations are truly interested in payout for their causes—which I believe they are—then shouldn't they support payout rules that will ensure that all of their accounts are distributed to the intended beneficiaries in a timely way?

Community foundations can truly distinguish themselves from commercial funds by supporting such a payout rule.

Any payout rule should be imposed on the sponsoring organization and not on the basis of each account.

Recognizing that payout requirements may soon be inevitable, some supporters of advised funds have suggested that they wouldn't mind if an overall 5-percent minimum-distribution rule was imposed on the sponsoring organizations that offer advised funds.

However this proposal is illogical and would be worse than maintaining the status quo.

A 5-percent floor would be an absurdly low percentage to apply to advised funds. The 5-percent minimum imposed on foundations in the 1969 tax law was based on the idea that foundations should be allowed to operate in perpetuity. However advised funds are essentially charitable checking accounts. They have no specific mission, and there is no reason for them to last forever.

Moreover, private foundations receive much less favorable tax treatment than advised funds. It is appropriate to link more generous tax benefits with more rigorous payout requirements.

Most important, it would also be inherently illogical to impose a payout requirement on the basis of the sponsoring organization rather then on the individual donor's account.

The donor is the one who benefits from the tax deduction, and, legal niceties aside, everyone understands that it is the donor who calls the shots regarding whether a distribution is made.

Given this combination of benefit and control, the only policy that makes sense is to impose payout requirements on the basis of each account.

A simple approach to bringing about real change would be this: Require donors setting up advised funds to name a charity that would receive any unspent funds at the end of seven years.

The sponsoring organization would simply need to track account spending, and at the end of seven years, it would automatically send unspent money to the donor's chosen charity. Donors could still make additional contributions to the fund any time; each of those could be tracked separately to follow the seven-year rule.

That's the kind of solution that balances everyone's needs—those of donors, charities, and society.

It's time for Congress to adopt such an idea before donor-advised funds capture even more money intended to serve the common good.

Ray Madoff is a professor at Boston College Law School, where she teaches about trusts and estates, and is the author of Immortality and the Law: The Rising Power of the American Dead.

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rhartsook • 5 days ago

Thank you for raising these issues. Has giving to charity really increased when you account for these funds? Of course, when they are given, they are counted again. If they were given to an institutions endowment or reserve, when they are expended they are not counted again.

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Andrew Schulz • 5 days ago

Interesting analysis and intriguing suggestions.

It may be useful and inform the discussion to know that our research at Foundation Source on more than 700 private foundations with endowments up to $50 million dollars, a segment that represents 98% of all private foundations in the U.S., shows that they averaged 11.7% in qualifying distributions in 2013. (Foundation Source 2013 Annual Report on Private Foundations http://www.foundationsource.co...

This is important because some fear that establishing a "floor" of 5% for donor advised funds would actually operate as a ceiling, tacitly giving donors an excuse to distribute 5% and no more. At least among non-huge private foundations, this does not appear to be the case.

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Russ Cohen • 5 days ago

THANKS, Chronicle of Philanthropy, for publishing this piece, and thanks, Ms. Madoff, for writing it.

I was (and perhaps others were) a bit confused by the article's title, "5 Myths About Payout Rules for Donor-Advised Funds", which I thought meant the article would be *against* the idea of payout rules, but I was happy to read it was just the opposite.

I agree that one potential downside of donor-advised funds (DAF) to charities is what can be a substantial time gap between when the funds are parked at the DAF-managing entity (the Fidelity Charitable Gift Fund, e.g.) and the time at which the funds are distributed to charitable organizations.

As the DAF-managing entities benefit from having a large pool of funds (to invest, cover their management expenses, etc.), there is little if any incentive for them to encourage donors to DAFs to direct payments to charities.

As I see it, though, there is another major shortcoming to charities that an increasing % of charitable dollars are going into corporate-managed DAFs: their

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Jon • 5 days ago

Note that Private Foundations are obliged to reveal their purpose, procedures, grantees, asset level and board membership on IRS Form 990, while donor advised funds can enjoy perfect invisibility within their sponsor's aggregated tax forms. There is no real access for fund raisers trying to identify potential DAF supporters unless the donors voluntarily makes themselves known to the organization. Community foundations as well as the Fidelity's of the world offer this opaqueness as an advantage for donors, though it is hard to explain why transparency is justified for private foundations but not donor advised funds.

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jan_masaoka • 2 days ago

I'm glad these issues are getting more attention. These days when a donor gives a lot of money to a community foundation it gets a lot of press but no one in the community has a raised heartbeat. It's about as exciting as hearing that a billionaire has plunked some money in your local bank . . . which is of course what they've done.

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