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Letter to Orrin G. Hatch on Donor-Advised Funds

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July 17, 2017

The Honorable Orrin G. Hatch Chairman
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Hatch,

We write in response to your request to stakeholders for input on tax reform, specifically with respect to the tax treatment of 501(c)(3) charitable organizations. We are professors of law at Boston College (Ray Madoff) and The Catholic University of America (Roger Colinvaux). Professor Madoff founded and directs the Forum on Philanthropy and the Public Good, which focuses on ways to improve the effectiveness and efficiency of the rules governing the charitable sector. Professor Colinvaux served for years on the Joint Committee on Taxation and writes extensively about tax policy and nonprofits.

The charitable sector in the United States is a source of strength and pride for all Americans, irrespective of party. Charitable giving by individuals exceeds \$250 billion every year and helps to fund a nonprofit sector that provides vital social services, education, health care, spiritual sustenance, scientific research and many more essential aspects of American civil society. The nonprofit sector is also a critical part of the economy and a source of employment for the nation's workforce.

The main reason for charitable tax benefits is to increase the flow of dollars to organizations engaged in charitable work. But right now, too many tax-subsidized contributions are being set-aside indefinitely—subject to no obligation for them ever to be put to active charitable use.

Accordingly, we focus our comments on two areas: channeling the incredible fundraising success of donor-advised funds to encourage more distributions from these funds to active charities; and improving the impact of private foundations by closing a loophole in the minimum payout rule and by making incentives for larger payouts more effective.

Establish a Payout Period for Donor-Advised Funds

Donor-advised funds (DAFs) have been one of the remarkable stories in charitable fundraising. DAFs operate like charitable checking accounts, where donors set funds aside in charitable vehicles and retain the power to advise distributions from their DAF accounts for charitable

purposes. From their infancy in the 1990s when the first commercially affiliated funds formed until today, DAFs have grown to dominate the charitable landscape. As reported by the Chronicle of Philanthropy, Fidelity Charitable is today's largest charity in terms of donations (surpassing all others by more than 20%). It is not alone, as DAF sponsors constitute five of the nation's top eleven charities. Given the regular double-digit growth of DAFs, there is every reason to think that this trend will continue.

Yet despite the tremendous growth of contributions to DAFs, charitable giving has remained flat at roughly two percent of disposable personal income. This suggests that DAFs are not increasing overall giving, but instead are attracting dollars that would otherwise be contributed directly to active nonprofits.

Understandably, DAFs are an attractive option because of their flexibility. Donors can time their charitable giving to achieve maximum tax benefits while still retaining the ability to advise where and when those funds will be directed. However, because current law does not require payouts from DAFs, donors may indefinitely defer charitable distributions from their DAF accounts, even across generations. While some individuals distribute their DAF accounts entirely within a single year, others make no distributions at all. While some DAF sponsors have high overall distribution rates, according to the IRS, a full 25 percent of DAF sponsors distributed less than one percent of their assets in a year.¹ Even for those DAF sponsors with higher payouts, the reported rates can be misleading because they include distributions to other donor-advised funds, which can be substantial.²

We recognize the convenience and tax benefits that DAFs offer to donors. However, the public value of DAFs does not occur until such time as funds come *out* of the DAF sponsor and make their way to active charities. Given the substantial sums flowing into DAFs, the significant tax benefits allowed for these contributions, and the ultimate purpose of charitable tax benefits to get money to organizations engaged in charitable work, we believe that Congress should impose a maximum time period for DAF accounts to be distributed to non-DAF charities. This could easily be accomplished by requiring donors (as a condition of the deduction) to name a non-DAF charity that would receive any undistributed funds at the end of the designated period.³ For example, if Congress were to impose a maximum time period of 10 years, then a donor who

¹ Paul Arnsberger, Donor-Advised Funds: An Overview Using IRS Data (2015).

<http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1017&context=philanthropy-forum>. There are several reasons why donors with the best of intentions may leave their donations in DAF accounts: charitable giving is difficult and donors may worry about spending unwisely, or may delay their giving due to procrastination or inertia. Further, there is a psychological allure to watching investments grow, particularly investments that are committed to good.

² According to a recent article in *The Economist*, Fidelity Charitable was the top recipient of distributions from three of the largest commercially affiliated DAF sponsors -- Fidelity, Schwab and Vanguard. In addition, the third largest recipient was the American Endowment Fund, another DAF sponsor. <https://www.economist.com/news/finance-and-economics/21719494-rise-dafs-may-be-much-about-tax-charity-philanthropic-boom>

³ We believe that it would be a mistake to follow the five percent payout model applicable to private foundations. An annual payout rule would remove the flexibility of donor-advised funds without significantly increasing the flow of dollars to nonprofits. Experience with private foundations suggests that donors are susceptible to treating floors as ceilings and therefore they may be more likely to think of their DAFs as perpetual accounts. In addition, since DAFs are sponsored by public charities, donors receive significantly greater tax advantages for their contributions to DAFs. As a result, it makes sense for DAFs to be subject to stricter payout terms.

funds a DAF in 2017 would be required to name a charity that would receive any remaining funds in the 2017 account by 2027.⁴ DAFs would maintain their flexibility because donors could change their charitable designations by simply making distributions from that account before the termination date. A maximum distribution period would not undermine the effectiveness of DAFs or their appeal to donors. It would simply establish a limit that would ensure that tax-benefitted dollars are granted to nonprofits within a reasonable period of time.

Prohibit Private Foundations from Using DAFs to Satisfy their Payout Obligations

In 1969 Congress became concerned that private foundations were providing too many tax benefits to donors, without any assurances that donated funds would benefit the public in a timely manner. In order to address this concern, Congress enacted a rule that required private foundations to distribute roughly five percent of their assets each year to public charities.⁵ Sensibly, the payout rule could not be evaded by a private foundation making distributions to other private foundations, because then the funds would simply await further distribution by that foundation.

Since the rise of donor-advised funds, some private foundations have been meeting their payout requirements by making grants to DAFs that are established by the foundation.⁶ The foundation can then advise distribution of the grant from the DAF to an active charity at a later date. This can have multiple benefits for the foundation: one is that the transfer counts for purposes of the foundation's payout (because the DAF sponsor is a public charity); another is that the foundation can disguise the source of the funding by flowing the funds through a DAF.

Neither of these benefits is consistent with the spirit of the rules that have governed private foundation conduct since 1969. The payout is intended to measure distributions to active charities, not to other investment funds. Further, because of the potential for abuse at foundations, they are held to higher standards of transparency. Allowing foundation to DAF transfers to count for payout purposes is inconsistent with the policies behind the private foundation payout and disclosure rules.

In order to address these concerns, Congress should provide that foundation to DAF transfers are not "qualifying distributions" for purposes of a private foundation's payout.

Encourage Private Foundation Distributions Through a Modified Excise Tax

Under current law, private foundations are generally subject to a two percent excise tax on their investment income. However, if a private foundation increases its annual distribution over its

⁴Multiple contributions could simply be grouped by year so that all 2017 contributions would be allocated to the 2017 fund (with an outside distribution date of 2027) and 2018 contributions would be allocated to the 2018 fund (with an outside distribution date of 2028).

⁵Qualifying distributions also include funds spent directly for charitable purposes.

⁶*The Economist* found that some private foundations distribute 90% of their qualifying distributions to DAFs. <https://www.economist.com/news/finance-and-economics/21719494-rise-dafs-may-be-much-about-tax-charity-philanthropic-boom>

historic distribution rate, then for that year the excise tax is reduced to one percent. This two-tiered system was intended to reward private foundations that make progressively larger grants.

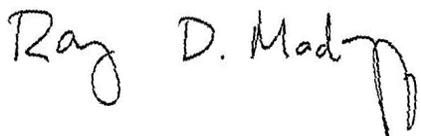
Private foundations have long sought to repeal the two-tiered excise tax in favor of a single one percent excise tax. The argument in favor of repeal is that the two-tiered system is complicated, and, paradoxically, can sometimes discourage large distributions because it can make it harder for the private foundation to qualify for the lower excise tax rate in subsequent years.

Although these arguments have merit, we believe that it is possible to simplify the excise tax and fix the design flaw. To that end, Congress could provide that private foundations are subject to a two percent excise tax (as currently) but the tax will be reduced to one percent in *any* year in which their qualifying distributions are six percent or greater; the tax could be reduced further to zero when qualifying distributions are at least eight percent. A mechanism such as this would simplify the excise tax while still retaining an incentive in the tax code for private foundations to make qualifying distributions above the statutory minimum of five percent, which too often has served as a ceiling on private foundation annual grant making.

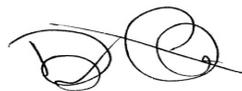
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It has been almost fifty years since the enactment of the Tax Reform Act of 1969 – the last seminal reform of charitable organizations. Today, charities still serve the neediest among us, strengthen civil society, promote pluralism, reduce the burdens on government, and fuel our economy. To accomplish these results, charities still depend on charitable donations. We believe that the modest changes we suggest in this letter would go a long way toward getting more dollars to active charitable nonprofits without creating significant new burdens on charities or undermining charitable giving.

Thank you for the opportunity to provide comments, and please do not hesitate to be in touch with either of us if you would like to explore these issues further.⁷



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⁷ In the interest of brevity, we kept our discussion here to a minimum. We have both written about the issues discussed here in more detail, as well as other important issues affecting the charitable sector. Please let us know if you would like additional information.