

Are Donor-Advised Funds Good for the Nonprofit Sector?

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Introduction

Donor-advised funds (DAFs) are an increasingly popular vehicle for charitable giving. There are now more than 500,000 individual DAFs across the United States, with assets upward of \$100 billion. All DAFs are managed by sponsors — tax-exempt public charities that can administer any number of individual DAF accounts.

Sponsors are often grouped into three categories:

1. Community foundations, which pool philanthropic investments in particular municipalities, regions, or states, have the longest history of DAF sponsorship.

2. National sponsors are not tied to any particular geographic or cause area. The largest national sponsors (Fidelity Charitable, Schwab Charitable, and Vanguard Charitable), sometimes called commercial sponsors, each contract primarily with a single for-profit financial institution for investment management and other services. Other national sponsors (for example, National Philanthropic Trust) are not linked to a particular for-profit financial institution.

3. Single-issue sponsors are often associated with academic institutions or faith communities.

In 2018, there were 603 community foundation sponsors, 54 national sponsors, and 332 single-issue sponsors.¹

A donor (sometimes termed DAF adviser or holder) receives a tax deduction when he or she contributes money or appreciated assets to a DAF. Donors can request that the DAF sponsor distribute funds to the operating charities of their choosing. Although donors can only advise, rather than require, a sponsor to make a gift, their advice is almost always heeded.

For a donor, the main advantages of a DAF include:

- A DAF can reduce a donor's tax liability by enabling the donor to claim a fair market value deduction for gifts of appreciated securities and complex assets, which then can be liquidated inside the DAF free of capital gains tax.²

¹National Philanthropic Trust, 2019 DAF Report <https://www.nptrust.org/reports/daf-report/>.

²Individuals who itemize deductions can deduct cash contributions to public charities of up to 60 percent of adjusted gross income (AGI), or cash contributions and capital gain property of up to 50 percent of AGI (with the capital gain property component capped at 30 percent of AGI). Unused deductions can be carried forward for up to five years. In 2020, individuals could deduct cash donations up to 100 percent of their AGI to ordinary public charities, but not to DAFs.

- A DAF can allow donors to make allocation choices on their preferred timetable — based on the nature of the philanthropic issues they wish to address, their ability to devote attention to grantmaking, or their interest in including others in decision making — without sacrificing tax benefits. By contrast, a donor who gives directly to an operating charity must make her gift in the year for which she wishes to claim a tax deduction.
- A donor who wants to divide the proceeds from a single complex asset among multiple charities can give the asset to a DAF, where it will then be liquidated and the proceeds distributed to grantees.
- The assets contributed to a DAF can grow tax-free.
- In some cases, DAF sponsors can facilitate socially motivated investments of donated assets.
- DAFs can reduce transaction and tax-compliance costs associated with charitable giving. The sponsor ensures that the prospective grantee is a legitimate charity, gets the grant out the door, and keeps track of the donor's giving history.
- Some sponsors offer professional advice on grantmaking to donors who hold DAFs with that sponsor.
- The fees for managing investments and grants are paid out of the donor's tax-deductible contributions to the DAF.
- Because grants to the recipient charities are made by the DAF, not the donor, the donor can be anonymous to grantees, though most donors do not choose anonymity.

DAFs also have potential disadvantages for donors. Although the donor's advice for directing grants is virtually always heeded, donors do not have formal, *de jure* control over either grants or investments.³ DAFs do not generally make multiyear commitments or grants with conditions; they are best used for unrestricted grants, gifts to a charity's general endowment

³ A donor's advice is not followed if the grant would not be used for a charitable purpose or would be made to an organization whose mission is inconsistent with the DAF sponsor's announced criteria. For example, some DAFs prohibit grants to organizations identified as hate groups by the Southern Poverty Law Center.

fund, or donations to existing programs. Also, except when negotiated by donors with large accounts, donors generally have a limited set of investment options for funds inside their DAFs.

DAFs have advantages and disadvantages for the recipient organizations as well. One advantage, which mirrors a feature mentioned above, is that DAFs can accept gifts of complex assets, liquidate them, and distribute them in cash to any number of organizations as the donor requests. Many smaller organizations lack the capacity to process such gifts. DAFs thus provide a way for those organizations, as well as donors, to benefit from donations of complex assets.

Additionally, although it is difficult to discern the magnitude of the phenomenon, DAFs may increase net donations to charities. Moreover, donations from DAFs may be more resilient to economic downturns than individual or foundation donations.⁴

A potential disadvantage for recipient organizations — and the source of the most vocal criticisms of DAFs — is that donors may be able to park their charitable assets in DAFs for indefinite periods of time, thus depriving nonprofit organizations of needed funds.

Recipient organizations may also be concerned that a DAF holder's choice to be anonymous deprives them of the opportunity to steward the gift, secure future donations, and decline grants from disreputable donors. This does not, however, appear to be a pervasive problem because DAF holders typically choose to reveal their identities to grantees.

Finally, DAFs may have advantages and disadvantages for the public — for governments, taxpayers, and society at large. Some of these parallel the factors mentioned so far.

- On the plus side, DAFs may increase net charitable donations generally — and especially donations to small organizations that constitute a mainstay of civil society.

⁴ See H. Daniel Heist and Danielle Vance-McMullen, "Understanding Donor-Advised Funds: How Grants Flow During Recessions," 48 *Nonprofit and Voluntary Sector Q.* 1066 (2019), <https://journals.sagepub.com/doi/full/10.1177/0899764019856118>.

- On the flip side, however, DAFs — insofar as they help donors claim larger tax benefits for their gifts — increase the cost of the charitable contribution deduction to the federal fisc.
- Some critics of DAFs argue that the delay between the time a donor makes a gift to a DAF and receives the tax deduction and the time the DAF funds are granted to operating charities significantly reduces the social impact of a DAF's charitable assets, though others contest the premises on which that critique rests.
- Critics of DAFs also have expressed concerns about DAFs' lack of transparency to the public. DAF sponsors publish only aggregate data based on all their accounts and not data about individual accounts, making it impossible for policymakers and researchers to examine, for instance, the composition and behavior of various sizes of funds.
- DAFs may facilitate gaming of some restrictions on private foundations, allowing such foundations to comply with the letter of the law while contravening the spirit.

This article examines the pros and cons of these various features and practices of DAFs. We should note at the outset that many issues are also relevant to other philanthropic vehicles, including direct giving and private foundations. For example:

- The question of whether giving sooner or later maximizes social value arises for private foundations, which are generally required to distribute at least 5 percent of their endowment annually, but are also permitted to distribute a larger amount, including 100 percent of their assets, in a single year.

- The question also arises for individuals making direct gifts from their checking accounts. While many donors give roughly the same amount each year, some might believe that the urgency of a problem calls for giving a large amount in a particular year, in effect borrowing against their future philanthropic budgets. Other donors may wish to husband their philanthropic resources while they consider the most effective ways to deploy them, and they may decide that a future gift will be more effective in achieving their goals.
- The issue of the valuation of complex assets arises in exactly the same way when individuals give directly to public charities other than DAFs. (It does not generally arise for foundations because gifts to foundations of assets that are not publicly traded are valued at their basis.)⁵
- Although individuals' gifts of cash or other assets are known to the recipient organizations, they are shielded from public view just as grants by DAFs, in contrast to grants from private foundations, which must be disclosed on their Form 990-PF information returns.
- For better or worse, individuals and foundations have only self-imposed restrictions on what organizations to give to, while some DAF sponsors place restrictions on the eligibility of donee organizations based on their ideologies or other attributes.

⁵ See Michelle Zhao, "Donor Advised Funds and the Valuation Issue" (Mar. 2020) (unpublished manuscript) (on file with the Stanford Law School Law and Policy Lab), for an excellent study of valuation issues.

Rationales for the Tax Deduction

Before turning to issues involving DAFs, it is helpful to note the rationales for government subsidization of charitable giving through the tax deduction:⁶

- the deduction facilitates donations to nonprofit organizations that provide public goods or services that may not be provided by the private marketplace or by government, especially when the demand for those goods or services reflects non-mainstream or minority interests;
- the deduction allows taxpayers to direct funds that otherwise would have been collected as tax revenue and spent by the government to organizations of its choice, thereby giving donors a voice in funding decisions; subsidizing private giving promotes the social value of giving, which contributes to a more altruistic society; and subsidizing private giving helps support civil society, which is both intrinsically valuable and can serve as a counterweight to the exercise of power by governments and business interests.⁷

⁶ See Roger Colinvaux, "Rationale and Changing the Tax Deduction," *Tax Notes*, March 25, 2013, p. 1453; Burton Weisbrod, "Toward a Theory of the Voluntary Non-Profit Sector in a Three Sector Economy" (1975), reprinted in *Econ. Nonprofit Insts.* 21, 21-44 (1986). These rationales do not purport to reflect the original history of the tax deduction, which was first enacted in 1917. They are fundamentally different from William Andrews's argument that a deduction is intrinsic to the purposes of an income tax because transfers to charity are not personal consumption. See Andrews, "Personal Deductions in an Ideal Income Tax," 86 *Harv. L. Rev.* 309 (1972). We do not include among these rationales what Peter Frumkin describes as "the private, consumptive, and expressive function of philanthropy . . . directed at meeting the psychic and social needs of donors . . . the self-actualization of donors by . . . allowing individuals to find meaning and purpose in their lives." Frumkin, "Strategic Giving: The Art and Science of Philanthropy" 18-19 (2006). Apart from the rationale of instilling the social value of altruism, it is not evident why government would subsidize self-actualization through philanthropy any more than it would subsidize self-actualization through, say, painting, sailing, or birding.

⁷ William Schambra writes: "We need a vital local civil society, right in front of our faces, to draw us out of that individualistic isolation, to engage us in the affairs of our own immediate communities, wherein we learn through direct, daily interaction with others to become responsible, self-governing citizens. Our vast, bewildering, and ever-growing profusion of nonprofits — in all their naïve, amateurish, bumbling, redundant glory — may appall those who want to see social services delivered in a neat, orderly, rationalized and centralized way. But Tocqueville would have said that this is a small price to pay for the education in democratic self-government provided by our thick, organic, local network of civic associations." Schambra, "The Centrality of Local Giving" para. 14-15 (2014).

An essential aspect of all these rationales is that they place decisions about what organizations to give to and how much to give in the hands of individual citizens. The main criterion for the tax deduction is that the organization is "organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes" under section 170 of the Internal Revenue Code.⁸ Within broad parameters,⁹ organizations have the freedom to define their own objectives and to decide how they will pursue those missions.

The rationales for the tax deduction are fundamentally inconsistent with the government's deciding at a granular level which causes are worth supporting and which are not. Government does have an interest in philanthropic dollars not being wasted. But the principal rationales for the deduction also imply that philanthropists should have leeway to shape the world according to their heterogeneous values and interests.

The Question of Timing

No issue involving DAFs has generated more controversy or calls for reform than that of timing. At the core of the controversy is the fact that an individual can claim a tax deduction when making a donation to a DAF but may delay directing grants from the DAF to operating nonprofit organizations for an indefinite period. Government regulations do not impose any payout requirements on DAFs. On average,

⁸ We have condensed the statutory definition of charitable contribution in the body text; see section 170(c) for the full list of criteria. Note that section 170, not the much more commonly cited section 501(c)(3), provides the criteria for deductibility. Section 501(c)(3) sets forth conditions under which the charitable organization will be exempt from income tax, and though those conditions overlap largely with the criteria for deductibility under section 170(c), the match is not complete; *id.* at section 501(c)(3).

⁹ Organizations that receive tax-deductible contributions are subject to a number of statutory restrictions on lobbying, election activity, and self-dealing. The Supreme Court also has held that an organization cannot receive tax-deductible contributions if its activities are "contrary to settled public policy." *Bob Jones University v. United States*, 461 U.S. 574, 585 (1983).

slightly more than 20 percent of DAF assets are granted to operating charities each year.¹⁰ This is substantially higher than the average annual payout of private foundations (slightly above 5 percent), though still, in the view of many DAF critics, far too low.

Some DAF sponsors nudge the holders of funds that have been dormant for several years, and some require a minimum payout.¹¹ For example, Fidelity Charitable's formal grantmaking policy requires that minimum annual grants, on an overall basis, be greater than 5 percent of average net assets on a fiscal five-year rolling basis. If this requirement is not met in a fiscal year and account holders on these giving accounts do not make grant recommendations within 60 days of notification, Fidelity Charitable will grant the required amounts in accordance with the Fidelity Charitable Trustees' Initiative in its sole discretion.

Schwab Charitable requires DAF holders to issue at least one grant every 2-1/2 years. If the DAF holder does not do so, Schwab Charitable states that it will make a grant from the DAF itself.

Those policies, however, are adopted voluntarily by sponsors and not mandated by law, and the rigor with which they are enforced cannot be assessed from publicly available data.

The delay between donating assets to a DAF and receiving the tax deduction on the one hand, and granting funds on the other, has been criticized on several grounds, all of which stem from the observation that funds that could be

put to work immediately by operating nonprofits are sitting in the DAF holders' investment accounts. For critics who view the delay in grants as intrinsically undesirable, this drawback is exacerbated by the seeming unfairness of donors' receiving the tax deduction years before their funds are put to charitable use. And as critics point out, the average payout figure is just that — an average. Some DAFs pay out much less.¹²

Rationales for Delaying DAF Payout

The CEOs of nonprofit organizations that deliver services to disadvantaged communities understandably want funds as soon as possible — on their watch. Yet the lives of their future beneficiaries are no less valuable than present ones.¹³ To be sure, a dollar spent now is, all else equal, preferable to a dollar spent later, if only because the cumulative effect of inflation means a dollar now will carry more purchasing power.

But dollars in DAFs are not stuffed under mattresses; they are invested in stocks, bonds, and other assets that tend to grow faster than the inflation rate. Hence the tradeoff posed by delay is not a dollar now versus a dollar later; in most times, it is a dollar now versus something more than a dollar later.

Moreover, donors may have good reasons to postpone grants, and society may have strong justifications for supporting donors' choices.

The first reason, donor effectiveness, is particularly relevant for donors who are new to philanthropy and who have not yet determined what causes to support, let alone identified the most effective strategies for achieving their goals

¹⁰ See National Philanthropic Trust, *supra* note 1. Note that the results reported include DAF-to-DAF transfers.

¹¹ See Fidelity Charitable, Program Guidelines, at 16-17 (Nov. 5, 2020), <https://www.fidelitycharitable.org/content/dam/fc-public/docs/programs/fidelity-charitable-program-guidelines.pdf>; Schwab Charitable, Program Policies, at 23-24 (Nov. 5, 2020), <https://www.schwabcharitable.org/public/file/P-5252372> (requiring granting after 30 months of inactivity); Vanguard Charitable, Policies and Guidelines <https://www.vanguardcharitable.org/company-policies/policies-and-guidelines> (last visited Nov. 5, 2020) (requiring granting after 30 months of inactivity); Greg Avis, "Donor Advised Funds: A Giving Tool for the Modern Philanthropist," Silicon Valley Community Foundation (Aug. 7, 2018), <https://www.siliconvalleycf.org/blog/philanthropy/donor-advised-funds-giving-tool-modern-philanthropist> (transferring funds to endowment after four years of inactivity).

¹² After the culmination of the Policy Lab but before the publication of this report, a new coalition named "the Initiative to Accelerate Charitable Giving" released a set of proposals for reform of DAFs and private foundations, including a proposal under which DAF donors could choose between (a) claiming an immediate tax deduction and committing to distribute donated funds or release advisory privileges within 15 years, or (b) waiting to claim a tax deduction until DAF dollars are distributed to charity. See Initiative to Accelerate Charitable Giving, *Common-Sense Reforms*, <https://acceleratecharitablegiving.org/reforms> (last visited Mar. 17, 2021). This report analyzes the arguments for and against the Initiative's stated goal of accelerating payouts, though not the arguments for and against the specific two-track proposal for reform of the charitable contribution deduction with respect to DAF gifts.

¹³ See Michael Klausner, "When Time Isn't Money," 1 *Stan. Soc. Innov. Rev.* 51 (2003), https://ssir.org/articles/entry/when_time_isnt_money.

and organizations to fund. Consider a donor who sells a start-up for millions of dollars and whose days continue to be occupied by her business. She is likely to be approached by many organizations arguing that they should be the objects of her philanthropy. And without time to consider other causes, she might choose to give to a safe and familiar organization, such as her alma mater. The postponement of grantmaking offered by a DAF affords her the time to evaluate a broader range of causes without sacrificing the tax benefits associated with a deduction in a high-income year. A more considered choice may allow the donor to derive greater personal fulfillment from her giving and, more important, may result in a decision that delivers greater social good.

A donor may also want to delay for cause effectiveness: The particular cause that she has decided to pursue, or the best strategy for impact, may demand funding later or sooner. For example, she may respond to the outbreak of COVID-19 by funding society's immediate needs, such as personal protective equipment. Or she may look ahead to support the delivery of a coronavirus vaccine once it has been developed, or, further down the road, to invest in rebuilding and improving the country's health and welfare systems post-pandemic. Alternatively, she may plan to make a series of annual grants to sustain small community organizations that couldn't effectively manage large one-time gifts.

Donors may also postpone giving for legacy reasons — for example, to instill philanthropic values in their children or grandchildren by involving them in decisions and giving them discretion after the donor's death. Although creating a legacy is essentially personal, it may perpetuate altruism that benefits society. Unless we have a compelling reason to believe a charitable dollar spent now accomplishes significantly more good than a charitable dollar (plus appreciation) spent in the future, delay for legacy reasons can be positive on the whole.

Of course, some donors leave their DAF funds unspent as a matter of inertia, through

procrastination or forgetfulness. Inertia is not categorically bad or good, however. Its social impact depends on whether it is more valuable to give now or later, which, as we have noted, depends on the nature of the cause to which the donor ultimately contributes and on investment returns.

Calls for DAFs and foundations to increase their payouts have been perennial, and have increased during the COVID-19 pandemic.¹⁴ As just noted, however, the social impact of the timing of spending depends on the nature of the cause and the donor's strategy for pursuing it. It's hard to argue against a sponsor's reminding or nudging donors with inactive accounts. The most plausible rationale for sponsors' mandating a minimum payout would be the assumption that relatively few donors actually have long-term strategies and that sponsors lack a robust method for inquiring into the reasons that underlie particular DAFs' low payouts.

The Rate of Return on Assets Invested in a DAF

The net benefits of postponing grants depend not only on the nature of the problem donors are tackling, but also on how DAF funds are invested before they are granted. Generally, the assets contributed to DAFs are invested in mutual funds holding stocks, bonds, and other securities. Returns are likely to track marketwide returns on a risk-adjusted basis. When returns are positive, they allow for larger ultimate grants.

Any calculation of net benefits and costs must include the fees charged by DAF sponsors. There are two types of fees.

Annual administrative fees, which cover the DAF sponsor's overall operating costs, are in the range of 0.6 percent of assets for an average-size DAF at the largest national sponsors. Investment fees, which are charged for managing invested assets in mutual funds or other vehicles, range from well below 0.1 percent of assets to above 1 percent. The percentage of both types of fees decline as DAF assets grow. Although larger amounts accumulated in funds allow sponsors to collect more in fees, we have not seen behaviors

¹⁴ See Larry Kramer, "Foundation Payout Policy in Economic Crises," *Stan. Soc. Innov. Rev.* (Jan. 4, 2021), https://ssir.org/articles/entry/foundation_payout_policy_in_economic_crises.

by major sponsors that discourage grantmaking. Donors' ability to transfer assets from a DAF at one institution to another acts as a competitive check on the fees sponsors charge.

Some sponsors also offer opportunities to make social investments, which include investments mainly in listed companies that have high environmental, social, and governance (ESG) ratings, and impact investments such as low-interest loans to small businesses in underserved communities. When DAF dollars are invested in enterprises that deliver social value, the good generated by those investments should be considered in the cost-benefit analysis as well.¹⁵

Financial vs. Social Return on Investment

Analogous to the financial rate of return on invested DAF assets, those assets may have a social return on investment (SROI) when put to use by the nonprofit organizations to which they are donated.¹⁶ For example, the economist James Heckman estimates that early childhood programs that contribute to their participants' cognitive and socioemotional learning development may have an annual SROI of 13 percent.¹⁷ A study of the anti-poverty program GiveDirectly reports an SROI of more than 30 percent.¹⁸ To the extent that the benefits conferred on one generation of preschoolers get passed on to their offspring, the SROI may be multiplied.

Referring to evidence of this sort, economist James Andreoni writes that if the social return on a DAF grant to a particular charity is greater than the financial return on the DAF investments, the donor should make the gift now; if it is less, the donor "can do the most for charity by saving now."¹⁹ Andreoni estimates that the average

financial rate of return on assets retained in a DAF account is about 5.9 percent per year in nominal (non-inflation-adjusted) terms. He concludes that "while not all charities are high performing, those that survive in the competition for donations are more likely to generate an SROI that is *no less than* that of the average for-profit investment."

We have no quarrel with a theoretical framework that compares financial and social returns. But the conclusion that Andreoni draws from that framework is open to serious doubt. Andreoni provides no basis for his conclusion that the charities most likely to attract donations are also likely to generate an SROI that beats the return on a DAF's investments. Donors choose among causes for many reasons: belief in the mission of the organization, personal fulfillment, habit, community mindedness, religious faith, and so on.²⁰ Some donors are "effective altruists" who seek out the highest-SROI causes, but they account for a very small fraction of all givers and giving.²¹ And unfortunately, most donors are provided few resources to determine the effectiveness of organizations in their chosen areas. It is wishful thinking that the organizations that survive in the competition for donations are high performing rather than good at fundraising.

Finally, Andreoni's analysis omits the possibility that DAFs enable donors to generate even higher SROIs. As noted, considerations of donor effectiveness and cause effectiveness sometimes counsel in favor of delaying philanthropic decision-making. Donors who think carefully about where to give their money are likely to make better decisions — that is, to generate a higher SROI — than donors who rush to write checks before year's end.

¹⁵ See *infra* pp. 293-296.

¹⁶ See "Social return on investment," Wikipedia https://en.wikipedia.org/wiki/Social_return_on_investment (last visited Nov. 5, 2020).

¹⁷ "Research Summary: The Lifecycle Benefits of an Influential Early Childhood Program," The Heckman Equation <https://heckmanequation.org/resource/research-summary-lifecycle-benefits-influential-early-childhood-program/> (last visited Nov. 5, 2020).

¹⁸ Johannes Haushofer and Jeremy Shapiro, "The Short-Term Impact of Unconditional Cash Transfers to the Poor: Experimental Evidence from Kenya," 131 *Q. J. of Econ.* 1973-2042 (2016).

¹⁹ See Andreoni, "The Benefits and Costs of Donor-Advised Funds," *Nat'l Bureau of Econ. Rsch.* (2018).

²⁰ See U.S. Trust & Lilly Family School of Philanthropy, "The 2016 U.S. Trust Study of High Net Worth," 35-40 (Nov. 5, 2020), http://www.ustrust.com/publish/content/application/pdf/GWMOL/USTp_ARMCGDN7_oct_2017.pdf.

²¹ The effective altruism hub GiveWell estimates that its research influenced approximately \$161 million in donations to its top-rated charities in 2018. "GiveWell's Impact," GiveWell <https://www.givewell.org/about/impact> (last visited Nov. 5, 2020). That is less than 0.4 percent of total U.S. charitable giving in 2018 (\$427.1 billion). "Giving USA 2019: Americans Gave \$427.71 Billion to Charity in 2018 Amid Complex Year for Charitable Giving," *Giving USA* <https://givingusa.org/giving-usa-2019-americans-gave-427-71-billion-to-charity-in-2018-amid-complex-year-for-charitable-giving> (last visited Nov. 5, 2020).

In sum, donors may have good reasons for making charitable contributions today rather than growing the DAF assets, or good reasons for postponing gifts. But one cannot say which is the better choice without understanding the charitable goals and strategies for achieving them.

Values-Aligned and Social Impact Investing

An assessment of the rate of return on invested DAF assets should consider whether they have been invested for social purposes and with what effects. An increasing number of DAF sponsors allow assets to be invested based on companies' ESG standards or to be deployed as impact investments that typically sacrifice some financial return to achieve social benefits. In this section, we ask whether and when such investments increase the value of donors' funds beyond their expected tax-free growth by allowing them to "do good while doing well."

As background, it is useful to make a distinction between (1) investments that are aligned with a donor's values and (2) investments that are so aligned and that also have social impact.

Values-aligned ESG investments

Most social investments consist of ESG, or socially responsible, investments.

Independent of having any effect on the company's behavior, ESG investors may wish to own stock in what they deem to be good companies or to avoid "dirty hands" or complicity by refusing to own stock in what they consider bad ones. They may be concerned with a firm's outputs — its products and services. They might want to own stock in a solar power company or avoid owning shares in a cigarette company. Or they may be concerned with a firm's practices — the way it produces those products and services. They might want to own stock in companies that treat their employees fairly, and to eschew companies that pollute the environment.

ESG index funds are offered by all the major national DAFs, some community foundations, and some single-issue sponsors. The fees for ESG funds are greater than for their comparable non-values-aligned options. At Fidelity, most domestic and international ESG funds run annual expense

ratios²² of between 0.1 percent and 0.2 percent while the ordinary index funds have expense ratios of less than 0.04 percent. Fidelity's Environmental Impact Access fund has a gross expense ratio of 0.99 percent, larger than any other fund offered. Vanguard's offerings show a similar premium for values-aligned choices: expense ratios between 0.12 percent and 0.17 percent for the ESG options compared with 0.03 percent and 0.08 percent for the ordinary domestic and international investment pools, respectively. The costs of Schwab's Socially Responsible Balanced portfolio exceed its Balanced portfolio by 0.09 percentage points.

Good ESG ratings sometimes predict good financial returns — perhaps because they signal that management is good at managing risks in general — but the evidence is mixed about whether ESG-oriented funds outperform or underperform the market net of management fees. Because ESG funds are mainly invested in publicly traded companies, it is far from clear that ESG investing will significantly expand access to capital for highly rated companies.²³

Impact investments

In addition to ESG options, donors to some DAFs can make impact investments that could create social value.

Investors who seek impact typically begin by identifying enterprises that are aligned with their values and whose goods, services, or production processes create social impact. They then make investments likely to increase those enterprises' impact. The Global Impact Investing Network defines an impact investment as an investment "made with the intention to generate positive, measurable social and environmental impact alongside a financial return."²⁴

But it is not easy to do this. Consider that for every would-be impact investor in a listed for-profit company there are likely hundreds or more ordinary commercial investors providing capital

²² An expense ratio is the fund's operational expenses divided by its average net assets for the same period.

²³ Paul Brest and Mark Wolfson, "How to Think About Risk in Philanthropy," *Stan. Soc. Innov. Rev.* 57 (Winter 2020).

²⁴ "What is Impact Investing?" Global Impact Investing Network <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing> (last visited Nov. 5, 2020).

to the company who care only about good financial returns. For socially motivated investors to have impact requires that their investments provide additional resources, beyond those supplied by commercial investors, that increase or improve a firm's socially valuable products or processes. It is virtually impossible to have impact in large-cap publicly traded companies. Impact investors must therefore look for opportunities in private equity and debt, often making investments on less favorable terms than ordinary commercial investors would make.

The IRC permits private foundations to make such concessionary investments as program-related investments (PRIs), whose primary purpose must be to further the foundation's charitable purposes rather than generate financial returns. The regulations treat PRIs like grants in some respects, including counting toward the foundation's required 5 percent annual payout.²⁵

Though PRIs are unique to foundations, DAFs may offer their donors similar investment opportunities, which we term quasi-PRIs. For example, DAF holders at the Chicago Community Trust can elect to invest funds in Benefit Chicago, a project that makes "low-interest loans and other investments to Chicago-serving nonprofits and social enterprises providing education, access to healthy food, quality affordable housing, job training and more."²⁶ Similarly, the Capital Preservation Pool of the Silicon Valley Community Foundation (SVCF), available to all DAF holders, is "invested in deposits at Community Development Financial Institutions (CDFIs) serving the greater San Francisco Bay Area . . . provid[ing] access to credit for low- and

moderate-income communities."²⁷ SVCF also offered donors the opportunity to participate in a subordinated debt investment of \$500,000 in the Eye Fund, an organization aimed at increasing access to affordable eye care globally.²⁸ The National Christian Foundation advertises a Sovereign's Capital impact investing fund focused on "companies led by faith-driven leaders." This fund is illiquid (10- to 15-year investment horizon), high risk, and concentrated in private markets.²⁹

Also mimicking PRIs, some DAF sponsors permit DAFs to make loans, often called recoverable or recyclable grants, to nonprofit organizations. For example, Fidelity Charitable has made recoverable grants to Calvert Impact Capital, a community development organization that lends funds to organizations working in low-income communities. Recoverable grants at Vanguard tend to be focused on nonprofits trying to improve the livelihoods of low-income individuals. Whatever is recovered from the investment must be regranted to charities.

Some community foundations also permit recoverable grants and other quasi-PRIs. SVCF, for example, authorizes these as part of its Capital Preservation Pool. One such recoverable grant at SVCF was a 2016 investment of \$100,000 in Fund Good Jobs, a nonprofit providing starting capital for small businesses around Oakland, California.

Access to recoverable grants and other impact investments has generally been limited to donors with high account balances. For example, Fidelity has launched an initiative with impact investment platform CapShift, allowing donors with more than \$500,000 to access a slate of preapproved impact options, including recoverable grant

²⁷ Capital Preservation Pool, SVCF <https://www.siliconvalleycf.org/capital-preservation-pool> (last visited Nov. 5, 2020).

²⁸ SVCF describes its investment in the Eye Fund as an example of the "but-for" aspect necessary for a successful impact: But for the recommendation of the DAF's "position as a subordinated debt holder, which de-risked the investment for others and attracted more capital, the charitable activity of accelerating the expansion of affordable eye care to low-income patients would not have occurred, or at the scale at which it did." "The Eye-Fund: A Program-related Investment Case Study," SVCF (June 15, 2018). <https://www.siliconvalleycf.org/blog/philanthropy/eye-fund-program-related-investment-case-study>.

²⁹ NCF Impact Investing Pool, National Christian Foundation <https://national.ncfgiving.com/forms/sovereignscapital> (last visited Nov. 5, 2020).

²⁵ Any return of capital from a PRI must be regranted in addition to the 5 percent required payout.

²⁶ Benefit Chicago, Chicago Community Trust https://www.cct.org/about/partnerships_initiatives/benefit-chicago/ (last visited Nov. 5, 2020).

options. Vanguard Charitable similarly restricts recoverable grants to donors with account balances of at least \$1 million.

Donors with high account balances also may have opportunities to self-direct investments, and these self-directed investments may be used to pursue social impact. For example, members of Fidelity's Charitable DonorFlex Program, which requires a minimum \$5 million initial allocation, may invest in hedge funds, private equity funds, and venture capital funds, including impact-oriented funds. Schwab, too, authorizes its largest accounts to suggest investment in hedge funds, private equity/venture funds, real estate funds, and other private funds, including funds with socially responsible mandates.

The costs and benefits of value-based investing

Donors with substantial philanthropic assets are increasingly interested in deploying them for ESG and impact investments. Although investors may pursue these opportunities through non-DAF mechanisms (for example, personal accounts, family offices, limited liability companies, and foundations), DAF sponsors that facilitate such investments may induce donors to make gifts to DAFs. To the extent that this increases their overall donations without diminishing the social impact of their philanthropic dollars, this benefits society.

However, there can also be costs to the extent that socially motivated investments diminish a donor's philanthropic assets without creating commensurate benefits.

Most ESG investments are likely a wash in this respect, not having social impact but not (apart from high management fees) detracting from the growth of a DAF's assets. In contrast, quasi-PRI impact investments typically sacrifice some financial return to achieve social impact. Whether they yield a net social benefit depends on the quality of the financial and social due diligence involved in making them. Recoverable loans may present the strongest case for systematically achieving positive outcomes.³⁰

³⁰ In theory, one would want to compare the net social return on the quasi-PRI with the return the amounts sacrificed would have had if they had been deployed purely philanthropically. In reality, except in extreme cases, such a calculation is impossible.

Smoothing Payout in Times of Financial Distress

Might DAFs provide a smoothing function for operating charities, increasing gifts during economic downturns? The theory is that while donors may be reluctant to commit new funds to charity when a downturn in the economy is affecting their own pocketbooks, they have already committed their DAF funds to charity. Consequently, they will have no reason to reduce recommended payouts from the DAFs, and some might recommend an increase in payouts in hard times.

A study by H. Daniel Heist and Danielle Vance-McMullen, examining charitable giving during the years after the 2007-2009 recession, concludes that "while other forms of charitable giving generally drop during economic downturns, we find that grants from DAFs remain relatively stable in recession conditions, despite reduction in contributions and decline in assets."³¹ The authors observe that DAFs may be an important resource to the nonprofit economy in future recessions. The coronavirus pandemic and the associated economic recession provide, unfortunately, a new opportunity to test this hypothesis.

The Effect of DAFs on Charitable Giving

DAF sponsors offer donors other advantages as well. They accept complex assets, including private company stock, and liquidate those assets before distributing funds to operating charities.

Donors can qualify for larger tax benefits by donating appreciated assets rather than cash. Although well-endowed nonprofits such as universities and art museums usually can sell those assets on their own, smaller community-based charities often cannot. Donors can overcome this obstacle by giving complex assets to a DAF and then, after liquidation, distributing their proceeds to an organization like a food bank that would not have been able to handle gifts of complex assets, or even ordinary securities. DAFs can thereby democratize the tax advantages of appreciated-asset donations by allowing grassroots groups to benefit from these gifts, too.

³¹ Heist and Vance-McMullen, "Understanding Donor-Advised Funds: How Grants Flow During Recessions."

DAFs make it easier for donors to maximize the value of the charitable deduction in other ways. A taxpayer facing a sale of a business or other liquidity event can get a deduction in the year of that event, when she is likely to be in a higher tax bracket, even before knowing which operating charity she would ultimately like to fund.

Also, donors whose annual contributions fall below the level at which they benefit from itemized deductions may make one large donation to a DAF every few years, and so benefit from an itemized deduction in that year, but then use a DAF to distribute funds over a number of years.

The net effect of these benefits on overall charitable giving is difficult to estimate, in part because the rise of DAFs since the 1990s has coincided with a number of confounding trends. For example, the last two decades have seen a sharp decline in church membership in the United States, which may have depressed donations because religious organizations historically have been the largest recipients of charitable gifts.³² At the same time, a booming stock market throughout most of that period might have increased the volume of donations, as individuals had more to give. The fact that charitable giving has remained around 2 percent of GDP for many years³³ may mean that DAFs have had little impact — or that DAFs have counteracted trends that otherwise would have decreased giving.

Economic theory can help us estimate the impact of DAFs even when the data are indeterminate. Because DAFs make it more convenient to give and allow many donors to claim larger tax benefits, they reduce both the hassle of giving and donors' out-of-pocket costs for each dollar they contribute to an operating charity. They thus reduce the after-tax price of charitable giving. Generally, when the price of a

good goes down, people buy more of it. Because DAFs reduce the after-tax price of giving, we would expect the net effect of DAFs on overall donations to be positive.

Leading critics of DAFs are concerned not only about the effect of DAFs on the overall volume of charitable giving but also about the effect of DAFs on the amount of money reaching charities each year. Just as DAFs reduce the after-tax price of charitable giving, they also reduce the after-tax price of delaying donations to operating charities.

It is worth underscoring, however, that by law, DAF assets cannot be used for any purpose other than a charitable purpose. Using DAF assets for noncharitable purposes exposes both the sponsoring organization and the DAF holder to penalties.³⁴ Even if DAFs result in less money reaching operating charities now, that outcome is only to be lamented if now is categorically better than later. And as noted, this is by no means inevitably true.

Professional Advice to DAF Holders

Some donors seek professional advice on such topics as which causes to pursue, which organizations to fund, and how to engage their families in philanthropy. Individual donors can purchase such advice on their own, but the cost is not tax-deductible. An advantage offered by foundations and DAFs is that the advice can be paid out of funds that have received a charitable deduction. DAF sponsors provide such advice to different degrees.

For example, Fidelity Charitable operates a donor guidance program, which offers assistance in designing a philanthropic strategy, performing philanthropic research, involving families in giving, and evaluating impact. Fidelity Charitable curates lists of trustworthy organizations to respond to disasters and other crises.

Many DAF sponsors provide personalized services to their largest donors. Fidelity Charitable's Private Donor Group helps donors

³² See Jeffrey M. Jones, "U.S. Church Membership Down Sharply in Past Two Decades," Gallup (Apr. 18, 2019) <https://news.gallup.com/poll/248837/church-membership-down-sharply-past-two-decades.aspx>; R.J. Reinhart, "Religious Giving Down, Other Charity Holding Steady," Gallup (Dec. 21, 2017). <https://news.gallup.com/poll/224378/religious-giving-down-charity-holding-steady.aspx>.

³³ Suzanne Perry, "The Stubborn 2% Giving Rate," *Chron. of Philanthropy* (June 17, 2013). <https://www.philanthropy.com/article/The-Stubborn-2-Giving-Rate/154691>.

³⁴ Sections 4966, 4967. One can imagine apocalyptic scenarios in which delay means that DAF assets never reach operating charities (for example, if an asteroid strike or a nuclear conflagration destroys the earth before DAF assets are distributed to grantees).

determine their mission, vision, values, and giving plans. The Private Donor Group also hosts family engagement programming, including workshops on family decision-making around giving, and a NextGen fellowship program.

Many community foundations provide DAF holders with similar kinds of assistance, with a focus on local charities. The SVCF assigns donors a philanthropic adviser to assist with researching nonprofits, developing a personal philanthropic mission statement, and connecting with like-minded donors. Its Community Connections program helps navigate the local nonprofit landscape and vet community organizations. SVCF also hosts speakers on various topics and runs several thematic giving circles on topics including the arts, the environment, Africa, and elements of the social safety net.

DAFs that are linked to particular causes also provide donors with advice. For example, the Jewish Community Foundation of Greater MetroWest New Jersey offers donors its “extensive knowledge of the local, national, and international Jewish community.”³⁵ It also links donors having common charitable interests and helps develop family philanthropy mission statements.

The ultimate measure of the advisory services offered by DAF sponsors is how much they improve donors’ effectiveness in deploying their philanthropic funds. This assessment would be difficult under any circumstances and, as discussed, it is confounded by the fact that effectiveness must be understood in terms of donors’ highly diverse and often incommensurable goals.

In any event, the DAF sponsors described above are satisfying a growing demand for

advice, and they appear to be doing this competently. Donors who seek advice enjoy an increasing range of opportunities from all types of sponsors.

Other Important Features of DAFs

Banned Grantees

By virtue of the laws defining DAFs, and reinforced by contracts with their donors,³⁶ DAF sponsors have absolute discretion to determine which public charities to fund. However, as a practical matter, DAF sponsors almost always respect their donors’ wishes as long as the designated recipient organization has public charity status.

The activities of some groups that enjoy public charity status may, however, be inconsistent with the missions of some DAF sponsors. How do DAF sponsors deal with requests to give to such organizations?

The large national DAFs are avowedly cause-neutral. For example, a spokesperson for Fidelity Charitable responded to the criticism that it funded hate groups: “As an independent charity that is cause-neutral, it is not Fidelity Charitable’s role to dictate what [donors’] values should be. Each of our individual donors has the right to decide which IRS-qualified charities they choose to support.”³⁷

Single-issue DAFs often have explicit policies on the subject. For example, the Jewish

³⁶ See, e.g., National Philanthropic Trust, Contribution Agreement <https://www.nptrust.org/wp-content/uploads/2020/10/Contribution-Agreement-NPT.pdf> (last visited Nov. 5, 2020) (“I understand that my gift of the property . . . is an irrevocable and unconditional contribution when received and accepted by National Philanthropic Trust (NPT), and that NPT retains exclusive legal control over contributed assets.”).

³⁷ Stephen Gandel, “Fidelity Charitable Fund Bankrolls ‘Hate Groups,’ Critics Say,” *CBS Moneywatch*, Dec. 10, 2019, <https://www.cbsnews.com/news/fidelity-401k-provider-criticized-for-funding-hate-groups/> (quoting a Fidelity Charitable spokesperson). Fidelity Charitable and Schwab Charitable recently declined to make grants to the National Rifle Association, citing reports of investigations into the NRA’s charitable status. See Michael Theis, “Fidelity and Schwab Ban Gifts From Donor-Advised Funds to NRA-Affiliated Charities,” *Chronicle of Philanthropy*, Dec. 4, 2019, <https://www.philanthropy.com/article/fidelity-and-schwab-ban-gifts-from-donor-advised-funds-to-nra-affiliated-charities>. Some commentators have expressed skepticism about whether the decisions were ideologically neutral. See Carter Skeel, “Two Leading Donor-Advised Funds Eliminate Grants to the NRA,” *Philanthropy Daily*, Dec. 12, 2019, <https://www.philanthropydaily.com/two-leading-donor-advised-funds-eliminate-grants-to-the-nra/>.

³⁵ About Us, Jewish Community Foundation of Greater MetroWest New Jersey <https://jcfgmw.org/about-us/> (last visited Nov. 5, 2020).

Community Foundation and Endowment Fund of San Francisco, the Peninsula, Marin and Sonoma Counties states that it will not make grants to organizations that promote anti-Semitism or “other forms of bigotry, violence or other extremist views,” that “[a]ctively seek to proselytize Jews away from Judaism” and that seek to undermine Israel’s position as a “secure independent, democratic Jewish state.”³⁸

Some DAF sponsors have signed on to the Amalgamated Foundation’s “Hate is Not Charitable” pledge to “reject donor recommendations to organizations engaged in hateful activities.”³⁹ The website explains: “Donors who utilize donor advised funds receive significant tax advantages, and the ability to make grants anonymously. . . . Using tax-deductible dollars to support hate groups undermines a shared value of democracy inherent to the logic of promoting the public interest. Promoting hatred is the opposite of public good.” Several DAF sponsors look to the Southern Poverty Law Center’s “hate map”⁴⁰ as a source for identifying hate groups.⁴¹

One cannot quarrel with cause-oriented DAF sponsors refusing to make grants to organizations anathema to their missions. The same can be said for community foundations, many of whose missions are to improve the lives of the very populations targeted by hate groups.

Reasonable people can differ about whether the large national DAF sponsors should exclude hate groups and, if so, how those groups should be identified. On the one hand, permitting the

support of groups that espouse odious ideologies is the inevitable cost of protecting freedom of expression in a heterogeneous society. The First Amendment forbids the federal government from denying tax deductions to such groups on the basis of their viewpoints.⁴² One also might be concerned about delegating the decision of what constitutes a hate group to a DAF sponsor or outside organization with a particular viewpoint.

On the other hand, the very rationale for the favorable tax treatment of DAFs is that DAF sponsors, not DAF holders, control the funds. It is difficult (at least rhetorically) for DAF sponsors to claim control for tax purposes but also disclaim responsibility over the destination of funds. Moreover, the First Amendment and free speech values do not require private actors such as DAF sponsors to support repugnant viewpoints with funds that they control.

DAF Holders’ Anonymity

Criticisms of DAFs’ giving to hate groups are often coupled with the concern that DAF holders’ recommended contributions can be anonymous. The main objection is that donors can shield their unpopular preferences from public view.

We are not persuaded that this is a valid criticism. For one thing, a donor can give anonymously and get a tax deduction through other means, such as donating through a revocable trust or LLC.⁴³ More fundamentally, anonymity protects donors from retaliation by their communities or employers regardless of the

³⁸ JCF Policy on Israel-Related Programming by its Grantees, Jewish Community Federation and Endowment Fund of San Francisco, the Peninsula, Marin and Sonoma counties <https://jewishfed.org/news/blog/jcf-policy-israel-related-programming-its-grantees> (last visited Nov. 5, 2020).

³⁹ “Hate is Not a Charitable Campaign,” Amalgamated Foundation <http://www.amalgamatedfoundation.org/hate-is-not-charitable> (last visited Apr. 18, 2020).

⁴⁰ Hate map (illustration) in “In 2019, we tracked 940 hate groups across the U.S.,” Southern Poverty Law Center <https://www.splcenter.org/hate-map> (last visited Nov. 5, 2020).

⁴¹ See, e.g., Grant Due Diligence Policy – October 2019, East Bay Community Foundation. <https://www.ebcf.org/wp-content/uploads/2019/11/Grant-Due-Diligence-Policy-FAQ.pdf>.

⁴² See *Big Mama Rag v. United States*, 631 F.2d 1030, 1034 (D.C. Cir. 1980) (“Although First Amendment activities need not be subsidized by the state, the discriminatory denial of tax exemptions can impermissibly infringe free speech.”); *National Alliance v. United States*, 710 F.2d 868, 875 (D.C. Cir. 1983) (noting that “the discriminatory denial of tax exemptions for engaging in particular speech can impermissibly infringe constitutionally protected rights,” but adding that the IRS may deny exemption based on criteria that are “neutral with regard to viewpoint”).

⁴³ A donor cannot claim a deduction for a charitable contribution of \$250 or more unless the donor has a contemporaneous written acknowledgement from the donee organization. Section 170(f)(8). However, there is no requirement that the acknowledgement identify a natural person. Thus, a donor can contribute assets to a revocable trust or LLC and then direct the trust or LLC to donate to the organization. The acknowledgement would then go to the trust or LLC, which, if structured correctly, would be treated as equivalent to the donor for federal income tax purposes.

organization's ideology. The landmark case of *NAACP v. Alabama*⁴⁴ forbade the state from requiring the disclosure of the NAACP's membership for precisely this reason. Just as a member of a progressive community may fear disclosure of a gift to, for example, the National Right to Life Committee, a member of a gun-toting community may fear disclosure of a gift to the Brady Campaign Against Gun Violence.

Two other concerns about donor anonymity are that recipient organizations may not wish to accept a gift tainted by a donor's conduct or ideology and do not want to lose the opportunity to steward a gift with the donor who directed it to them.

As for the first concern, an organization concerned about the source of an anonymous grant can decline it. As for the second, the vast majority of DAF grants are not anonymous.⁴⁵ For many DAF sponsors, disclosure of the donor's name is the default.⁴⁶

Atypical Transfers of Funds to and from DAFs

The typical transfer of funds to a DAF is in the form of the donor's own cash or stock. The typical transfer of funds from a DAF is to a public charity. But several kinds of atypical transfers have aroused concerns.

Private foundation to DAF

Private foundations may make grants to DAFs as they can to any other public charities, and there are some legitimate reasons for doing so.⁴⁷

Two reasons that seem illegitimate, however, are to avoid the 5 percent required distribution and to make anonymous gifts. The minimum payout and disclosure requirements are among the conditions attached to the benefits of operating as a foundation. DAF sponsors should

examine grants received from foundations to ensure that they are made for legitimate reasons and not to circumvent the requirements imposed on foundations. Fidelity Charitable, the largest DAF sponsor, prohibits private foundations from opening DAF accounts,⁴⁸ though other DAF sponsors maintain more permissive policies.⁴⁹

DAF to borderline private foundation

Transfers from DAFs sometimes are used to help other public charities avoid private foundation status. For many readers, the term "private foundation" brings to mind a grantmaking organization. But under the IRC, a private foundation is a section 501(c)(3) organization that does not meet the public support test required of most types of public charities. While gifts to private foundations are tax-deductible, public charities receive more favorable treatment in several important respects.

Some organizations — including churches and other religious congregations, schools and universities, hospitals, and medical research organizations — are per se public charities.⁵⁰ Another type of organization can qualify for public charity status if it "normally receives a substantial part of its support" from the government or "from direct or indirect contributions from the general public."⁵¹ This is known as the public support test.

The standard way for an organization to satisfy the public support test is to show that it normally receives more than one-third of its support from gifts, grants, contributions, and membership fees. Grants from other public charities, including DAFs, count toward the one-third requirement. However, donations from a substantial contributor — a donor whose contribution constitutes more than 2 percent of the organization's total budget — does not count toward the requirement.

DAFs can help organizations meet the public support test even though those organizations rely very heavily on a small number of substantial

⁴⁴ *NAACP v. Alabama*, 357 U.S. 449 (1958).

⁴⁵ Interview with representatives of DAF sponsors indicated that the rate of anonymous giving was in the low single digits.

⁴⁶ See Eden Stiffman, "How to Land Donor-Advised Fund Gifts," *Chron. of Philanthropy* (Jan. 7, 2020). <https://www.philanthropy.com/article/How-to-Land-Donor-Advised-Fund/247787>.

⁴⁷ See Ken Nopar, "Why Private Foundations Establish Complementary Donor Advised Fund Accounts," American Endowment Foundation <https://www.aefonline.org/why-private-foundations-establish-complementary-donor-advised-fund-accounts> (last visited Nov. 5 2020).

⁴⁸ Fidelity Charitable, *supra* note 11, at 2.

⁴⁹ See, e.g., Schwab Charitable, *supra* note 11, at 9; Vanguard Charitable, *supra* note 11.

⁵⁰ Section 170(b)(1)(A)(i)-(iii).

⁵¹ Section 170(b)(1)(A)(vi).

contributors or large grants from private foundations. Instead of giving directly to an organization, a substantial contributor can donate money to a DAF and then recommend a grant from the DAF to the organization. Because an entire grant from a public charity counts toward the one-third requirement, and because DAFs are public charities, the entire grant can count toward the one-third requirement. That, in turn, can help the donee organization maintain public charity status. Although this is legal, it is also clearly an end run around the public support test.⁵²

DAF to DAF

Although DAFs generally cannot make grants to private foundations,⁵³ they can make grants to other DAFs. A donor's ability to make such grants is an important mechanism for keeping DAF sponsors competitive on whatever criteria interests the donors — for example, administrative costs, speed of grantmaking, or advisory services. They may also be used to avoid a DAF sponsor's policies, such as a required distribution or a ban on grants to particular organizations. Readers can decide for themselves whether this is a matter of concern.

In any event, although DAF-to-DAF transfers account for a very small percentage of grants, they should be excluded from calculations of a DAF's payout.

⁵² The public support test — and more specifically, the provision of greater tax benefits to organizations that pass the test — has several plausible justifications. For one, the test arguably subsidizes the strengthening of civil society, because organizations that build social capital and associational bonds across a broader range of constituents receive larger benefits. Second, the test ensures that the organizations that receive the largest tax benefits also survive a market test. Organizations that are poorly managed, or managed to serve the private interests of a small set of individuals, also may be less likely to attract contributions from a broad donor base. See Daniel J. Hemel, "Tangled Up in Tax: The Nonprofit Sector and the Federal Tax System," *The Nonprofit Sector: A Research Handbook* 144, 158-160 (2020).

⁵³ See section 4966(c). There are two exceptions to this rule. First, DAFs can make transfers to a particular type of private foundation called a private operating foundation. These are private foundations with substantial charitable activities of their own (beyond grantmaking). By far the largest and best-known of these is the J. Paul Getty Trust, which runs the Getty Museum in Los Angeles. Second, DAFs can make transfers to private foundations (or to non-section 501(c)(3) organizations) if the DAF sponsor exercises expenditure responsibility regarding the grant. This means the DAF sponsor oversees the expenditure to ensure it is used for charitable purposes.

Conflicts of Interest

Another concern about DAFs is that their structure may create conflicts of interest between sponsors and donors, or between sponsors and the broader public.

The most obvious concern involves payout, because it may be in the sponsor's interest to maximize assets under management. This concern may be especially acute for DAF sponsors linked to for-profit financial institutions, but it is not limited to those sponsors.

For example, a single-issue DAF sponsor or community foundation may derive revenue from managing DAF assets that it can use to fund its other charitable activities. Because DAF sponsors generally charge fees that are based on assets, they have a financial incentive to discourage (or at least not encourage) faster payouts.

A number of factors may help to keep these conflicts of interest in check, though whether they do so is open to question.

First, sponsoring organizations for DAFs linked to for-profit financial institutions have their own boards, whose members hold fiduciary duties to the sponsoring organization.

Second, revenues from DAF administrative fees and investment management services generally constitute a very small portion of total revenues for financial institutions with linked DAFs. For example, Fidelity Investments, the for-profit financial institution, collected \$58.9 million from Fidelity Charitable in 2017, which constituted about 0.3 percent of Fidelity Investment's total revenue.

For-profit financial institutions likely want their DAF holders to be satisfied and to engage frequently with their DAFs to increase the probability that DAF holders will become loyal customers for other financial products. For that reason, they may have stronger incentives to encourage frequent grants than to push for delay.

Single-issue sponsors and community foundations, for their part, may care more about pushing dollars out the door to organizations in their cause areas or communities rather than skimming administrative fees off the top of their DAFs.

One sign that conflicts of interest may not be too worrisome is the fact that, as mentioned,

many sponsors follow policies and practices that nudge or force donors to recommend grants.

Finally, all DAF sponsoring organizations must disclose financial information on annual Form 990s filed with the IRS. Insofar as sunlight is the best disinfectant, these disclosures, which are available to the public, provide an important check on conflicts of interest.

However, DAF sponsors differ considerably in how much information they actually disclose. For example, Schwab Charitable and Vanguard Charitable provide detailed disclosures, including the salaries of top employees, overall salaries and wages, other employee benefits, legal services, advertising, travel, and much more. Fidelity Charitable rolls all of these expenses into a single-line item, reporting aggregate payments to Fidelity Investments.

Further disclosure would help other stakeholders better evaluate conflict-of-interest concerns.

Relationship to Private Foundation Rules

At several points in this article, we have noted similarities and differences between DAFs and private foundations. As a practical matter, DAFs often function as mini private foundations for their holders.

As a tax law matter, however, DAFs are subject to much more favorable rules. For one thing, donations to DAFs and other public charities are deductible up to a higher percentage of AGI. For another, gifts of most types of capital gain property to DAFs and public charities can be deducted at FMV, whereas donors to private foundations can claim FMV deductions only for gifts of publicly traded stock.

Private foundations also are subject to a 5 percent annual payout requirement, a 1.4 percent tax on net investment income, and a number of other excise taxes, self-dealing restrictions, and disclosure requirements that do not apply to DAFs or other public charities.

A natural question is whether the differential treatment of DAFs and private foundations can be justified. The best argument for treating DAFs as public charities is that, like other public charities that are not per se public charities, DAF sponsors are subject to a market test. If a DAF sponsor cannot continue to draw new donations (for

example, because the sponsor mismanages DAF funds), it will ultimately flunk the public support test and cease to qualify as a public charity.

DAFs escape from the private foundation rules in the same way that other public charities can escape from them: by showing that they enjoy substantial public support.⁵⁴ And they can do that only if they convince a critical mass of donors that they will be good stewards for those donors' gifts (at least until the donor recommends that those funds be distributed to operating charities).

When an organization cannot pass the market test, there is arguably greater cause for concern that the organization may be wasting, misusing, or mismanaging funds. That, in turn, plausibly justifies heightened government scrutiny and tighter constraints.

In those circumstances, the more rigorous and less generous private foundation rules kick in. The 5 percent payout requirement serves as a check on neglect. The private foundation self-dealing restrictions and disclosure requirements recognize the greater risk of self-enrichment. The less generous tax benefits serve to nudge donors toward organizations where the risk of waste or misuse of assets is lower.

This rationale for distinguishing between DAFs and private foundations also underscores the concerns regarding private-foundation-to-DAF and DAF-to-borderline-private-foundation transfers. If the public charity/private foundation distinction is justified, the use of DAFs to circumvent the restrictions on private foundations is worrisome. So too is the use of DAFs to maintain public charity status at organizations that otherwise would fall into private foundation classification.

Note, though, that in both cases reform does not require any change to rules that apply directly to DAFs. Congress could change the 5 percent payout rule for private foundations so that private foundation donations to DAFs do not qualify.

⁵⁴ Some organizations that are not per se public charities and do not satisfy the public support test nonetheless may become eligible for public charity status by passing the gross receipts test. Section 509(a)(2). Gross receipts test public charities typically pull in substantial mission-related income (for example, receipts from admissions, merchandise sales, and performance of services related to an organization's charitable activities). DAF sponsoring organizations typically will achieve public charity status based on the public support test rather than the gross receipts test.

Congress also could amend the public support test so that donations from DAFs do not count toward the one-third requirement. Treasury and the IRS may be able to accomplish these reforms through regulations without further congressional action.

Conclusion

It is almost a cliché for academic articles to conclude with a call for more data. But this is surely the case with DAFs.

Estimates of the benefits and costs of DAFs are fraught with unknowns. Some information that might shed light on these issues lies in the confidential records of DAF sponsors; other aspects must be gleaned from interviews of the donors and recipients themselves.⁵⁵

A bill proposed in the California Legislature, but later withdrawn, would have mandated disclosure of information about individual funds, ostensibly to help the state attorney general ascertain whether those funds or accounts are being properly administered.⁵⁶ To the extent such disclosure could be made without revealing the identity of donors, it would provide information to help policymakers, researchers, and the public understand DAF payouts in a way that aggregate information does not.

But it probably would not require great forensic talent to identify the donors of some very large funds at, for example, the SVCF. Those donors would likely be subject to external pressures to distribute the funds at or above the 5 percent rate required of foundations. As we discussed earlier, this is not necessarily a good outcome.⁵⁷

We are skeptical about whether, at this time, governments should impose significant additional requirements on DAFs. Rather, we suggest that DAF sponsors, together with groups representing nonprofits, collaborate to develop standards for best practices. There is a fairly recent analogy in the Panel on the Nonprofit Sector, convened by Independent Sector in 2004 in the shadow of proposed legislation to increase the accountability of foundations and operating nonprofits.⁵⁸ After two years of deliberation, the panel released a set of “Principles for Good Governance and Ethical Practice,”⁵⁹ which have become standards for the sector.

The creation of a similar group focused on the practices of DAFs would be timely and might lead to productive cooperation among the parties. ■

⁵⁵Erinn Andrews and Rebecca Shamash, *Giving Vehicle Use Among High-Capacity Donors in the Bay Area and Implications for Nonprofits* (Feb. 2021), <https://pacscenter.stanford.edu/publication/giving-vehicle-use-among-high-capacity-donors-in-the-bay-area-and-implications-for-nonprofits>.

⁵⁶A.B. 1712, 2019-20 Leg., Reg. Sess. (Ca. 2020). A subsequent bill, A.B. 2936, would have mandated only that “The Attorney General shall establish a classification for sponsoring organizations that maintain one or more donor-advised funds . . . [and] shall receive reasonably current, periodic reports as to all charitable trusts or other relationships of a similar nature, which will enable the Attorney General to ascertain whether they are being properly administered.” A.B. 2936, 2019-20 Leg., Reg. Sess. (Ca. 2020). The bill, opposed by community foundations and national DAF sponsors, was removed from the State Assembly’s legislative calendar. See Michael Kavate, “Not going away.’ California DAF Reform Bills Die but Debate Likely to Persist,” *Inside Philanthropy* (Aug. 18, 2019), <https://www.insidephilanthropy.com/home/2020/8/19/not-going-away-california-daf-reform-bills-die-but-debate-likely-to-persist>.

⁵⁷The bill would also have required a description of the DAF sponsor’s policy regarding funds that do not make distributions during a specified period of time, and of how the sponsor monitors and enforces compliance with that policy — or a statement that it does not have one.

⁵⁸See NonProfit Panel, “About the Panel on the Nonprofit Sector,” <http://www.nonprofitlawblog.com/assets/> (last visited Nov. 5, 2020). (One of the authors of this article, Paul Brest, was a co-convenor of the panel.)

⁵⁹Independent Sector, *Principles for Good Governance and Ethical Practice* <https://independentsector.org/programs/principles-for-good-governance-and-ethical-practice/> (last visited Nov. 5, 2020).