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The Missing Tax Benefit of Donor-Advised Funds

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In this report, Brooks discusses donor-advised funds and the tax policy issues they raise. He finds that donor-advised funds generate a small tax benefit at best and may often generate a tax cost for many donors. Further, what little tax benefit is created is largely soaked up by the funds' investment managers.

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I. Introduction

The second largest charitable organization in the country in terms of annual money raised is not the Red Cross, the Salvation Army, or the YMCA — it's Fidelity Investments. The sixth largest is Charles Schwab Corp. Vanguard Group Inc. is No. 10.[1] Needless to say, Fidelity, Schwab, and Vanguard are not running hospitals or soup kitchens. Rather, they are the three largest sponsoring organizations of donor-advised funds (DAFs).

DAFs are accounts established by contributions from charitable donors to a sponsoring organization that pools and manages many different DAFs.[2] The DAF then makes distributions to operating charities based on the advice of the donor.[3] Because the sponsoring organizations are, by definition, described within section 170(c),[4] contributions by a donor into a DAF are tax deductible.[5] Importantly, the DAF need not make any distributions immediately for the original donor to receive the deduction. Because the donation is to the sponsoring organization itself, and the sponsoring organization is a charitable organization, the original gift is fully deductible.

DAFs have grown immensely in recent years. According to the National Philanthropic Trust, there are now more than 238,000 DAFs that together hold more than $70 billion in assets.[6] In 2014 contributions to DAF were $19.66 billion, and DAFs made $12.49 billion in distributions to operating charities.[7] The average DAF has about $296,000 in assets,[8] so they are sometimes described as mini-private-foundations and marketed accordingly. For those without the assets or interest to set up and operate a private foundation, DAFs achieve a similar result with less cost and hassle. What's not to love?

However, DAFs do not provide the tax benefits that are sometimes assumed. Although they are certainly more tax beneficial than private foundations, that's a pretty low bar.[9] In fact, in many situations DAFs impose a net tax cost on most

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[1] "2015 Philanthropy 400: A Gold Mine of Data on a Quarter Century of Giving," *Chron. Philanthropy*, Oct. 29, 2015.

[2] *See* section 4966(d)(2)(A). A DAF does not include a fund or account that makes distributions only to a single, identified organization or government entity (section 4966(d)(2)(B)(i)), or one for which the donor or the donor's designee advises on which individuals receive grants for travel, study, or other similar purposes under some circumstances (section 4966(d)(2)(B)(ii)).

[3] *See* section 4966(d)(2)(A)(iii).

[4] *See* section 4966(d)(1).

[5] *See* section 170(a) and (c).

[6] National Philanthropic Trust, "2015 Donor-Advised Fund Report," at 3, Table 1 (2015).

[7] *Id.*

[8] *Id.*

[9] For example, private foundations have a lower percentage limitation on gifts (see section 170(b)(1)(B) and (D)), and the deduction for gifts of appreciated assets is often limited to the donor's basis (see section 170(e)(1)(B)(ii)). Further, private foundations face a series of excise taxes. *See, e.g.*, sections 4940 (2 percent tax on net investment income), 4941 (excise taxes on

(Footnote continued on next page.)

donors relative to a direct donation. Moreover, a donor would in many cases be worse off donating today to a DAF than waiting and later donating directly to the operating charity. Taking an immediate and large deduction does not in itself create a tax benefit relative to taking a deduction later, and may even create a tax cost. As I show below, this is because of the interaction of the deduction with the ability to avoid capital gains taxation on donations of appreciated property — because the value of a future deduction can grow tax free in a donor's personal account, donating today to a DAF to get an immediate deduction will not be beneficial. The ability to avoid capital gains taxation also means that the value of tax-free growth in a DAF is limited to the taxes on annual income, like interest, dividends, and any net capital gain from rebalancing.

Furthermore, in the cases where there is some positive tax benefit, the additional management fees imposed by the sponsoring organizations eat away most or all of it. Fidelity, Schwab, and Vanguard charge annual fees of 0.6 percent of assets for the first $500,000 in each DAF, in addition to any investment fees charged by the underlying mutual fund or other investment vehicle.[10]

If my claims are right, the rapid growth of DAFs is a bit of a puzzle. While some of that growth can perhaps be explained by donors who truly value the nontax benefits of a DAF, some is likely the result of a misunderstanding of the tax benefits, in part because of marketing by the sponsoring organizations. That said, DAFs provide real benefits from the simplification and centralization of giving. If the fee for those services (0.6 percent of DAF assets) is offset by any tax benefits from holding assets in a DAF, in a sense taxpayers are picking up the tab for the simplification services. Therefore, the tax benefit of a DAF isn't missing; it's just being soaked up by the DAF sponsoring organizations as a fee for their services.

II. Background on DAFs

Although DAFs have grown rapidly in recent years, their basic structure goes back to at least the 1930s. The first were established by community foundations (also known as community trusts), which pool donations from many donors to centralize investment and grant-making. The first community foundation was likely the Cleveland Foundation, established in 1914.[11] For the first few decades, community foundations existed just as one pool of money controlled by the foundation itself. But in 1931 the New York Community Trust established the first DAF,[12] a separate pool that was controlled by the foundation but gave the donor some voice on distributions in the form of advice. Another DAF was created in 1935,[13] and more followed.

In 1969 Congress amended the tax code to impose tighter rules on gifts to private foundations,[14] but it provided a carveout for foundations that operate like community foundations — those that pool donations into a common fund and meet specified payout requirements.[15] Those foundations are treated as publicly supported 50 percent charities — those for which donors can take a donation deduction of up to 50 percent of adjusted gross income.[16] If the separate funds or trusts had instead been viewed as separate entities, they would have failed the public support test.

But it was not immediately clear whether DAFs would be given the same benefit. In 1983 the IRS denied tax-exempt status to a foundation that resembled a DAF sponsoring organization, claiming that it was merely a conduit for private foundation-like entities that were using the sponsoring organization as a way to avoid being labeled as private foundations.[17] Further, the IRS claimed that the foundation was essentially just a money-making venture, because it took fees from the donors to manage the accounts and also from grant applicants.[18] The foundation brought suit for a declaratory judgment on its tax-exempt status, and the Claims Court held in 1987 that the foundation did in fact qualify for tax-exempt status under section 501(c)(3).[19]

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self-dealing), 4942 (excise tax on undistributed income), and 4943 (excise tax on excess business holdings).

[10] *See* Fidelity Charitable, ''What It Costs,'' *available at* http://www.fidelitycharitable.org/giving-account/what-it-costs.shtml; Schwab Charitable, ''Fees and Account Minimums,'' *available at* http://www.schwabcharitable.org/public/charitable/donor_advised_funds/fees_and_account_minimums; and Vanguard Charitable, ''Fees and Expenses,'' *available at* https://www.vanguardcharitable.org/individuals/fees_and_expenses.

[11] *See* Cleveland Foundation, ''Our History,'' *available at* https://www.clevelandfoundation.org/about/history.

[12] *See* Victoria B. Bjorklund, ''Charitable Giving to a Private Foundation: The Alternatives, the Supporting Organizations, and the Donor-Advised Fund,'' 26 *Exempt Org. Tax Rev*. 107, 114 (2000); and New York Community Trust brochure, ''Donor-Advised Funds in the New York Community Trust.''

[13] *See* Winston-Salem Foundation, ''Milestones,'' *available at* http://www.wsfoundation.org/netcommunity/page.aspx?pid=825.

[14] *See* Tax Reform Act of 1969, P.L. 91-172, section 101.

[15] *See* section 170(b)(1)(F)(iii), added by TRA 1969, section 201(a).

[16] *See* section 170(b)(1)(A)(vii) (granting 50 percent charity status to private foundations described in section 170(b)(1)(F)).

[17] *Nat'l Found. Inc. v. United States*, 13 Cl. Ct. 486, 490 (1987).

[18] *Id.*

[19] *Id.* at 494.

Perhaps emboldened by that holding, Fidelity established the first commercial gift fund in 1991, and the IRS granted its application for tax-exempt status.[20] Vanguard followed in 1997[21] and Schwab in 1999,[22] as did other commercial sponsoring organizations.[23] Here, I distinguish the commercial gift funds from the community foundations and trusts that were already operating DAF-type funds. Community foundations are established independently for purposes of charitable grant-making. Commercial gift funds, on the other hand, are established by for-profit investment managers. To be clear, however, many of the issues discussed below are the same whether the DAF sponsoring organization is a community foundation or a commercial gift fund.[24]

The commercial gift funds have grown rapidly. In 2003 the three main commercial gift funds had total contributions of about $1.1 billion, but by 2013, total contributions had risen to about $6.7 billion. Total assets have similarly grown from $3.7 billion to $24.2 billion. Almost all the growth in assets is from contributions; investment returns have been relatively smaller, averaging 0.96 percent (Schwab), 1.67 percent (Vanguard), and 2.44 percent (Fidelity) over that same period. (See figures 1-4 for more data.[25])

Seeing this rapid growth, the IRS,[26] commentators, and ultimately Congress demanded more scrutiny. In 2000 Treasury proposed tightening up the test for whether a sponsoring organization qualifies as a public charity by requiring a payout rate and that all distributions go to public charities or governmental entities.[27] In the Pension Protection Act of 2006 (PPA, P.L. 109-280), Congress added the first statutory definitions of the terms ''donor-advised fund'' and ''sponsoring organization'' in enacting excise taxes on non-charitable distributions, excess benefit transactions, and similar misuses of charitable funds.[28] The PPA also amended the code to state that contributions to a DAF would not be deductible unless the sponsoring organization meets specified criteria[29] and supplies the donor with written acknowledgment that the sponsoring organization has exclusive legal control over the assets contributed.[30] The PPA also instructed Treasury to undertake a study on DAFs, in particular on whether the immediate deduction was appropriate given that donors still had some implicit control over the funds, and whether DAFs should have a required payout rate.[31]

In 2011 Treasury issued the required report. The report stated that allowing an immediate deduction is appropriate because the donors part with control of the assets and that the lag between donation and charitable use is no different than in other charitable contexts, such as charitable endowments, and that the same deduction rules used for other organizations should apply. The report also found that payout rates for DAFs are higher than for private foundations, and so it would be ''premature to recommend a distribution requirement for DAFs at this point.'' Regarding donor advice, the report stated that even if the sponsoring organization feels ''an obligation to use donated funds in a manner preferred by the donor,'' that does not disqualify the gift from being completed, and that the sense of obligation is not unique to DAFs.[32] Treasury implied, however, that additional data and research could suggest different regulatory responses, especially as the effects of the new rules became clearer over time.[33]

Both before and after the report, commentators have been concerned that a deduction is granted immediately even though the funds won't be used until some point in the future (or possibly never).[34]

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[20]*See* John F. Coverdale, ''Legislating in the Dark: How Congress Regulates Tax-Exempt Organizations in Ignorance,'' 44 *U. Rich. L. Rev*. 809, 814 (2010); Ray D. Madoff, ''It's Time to Reform Donor-Advised Funds,'' *Tax Notes*, Dec. 5, 2011, p. 1265, at 1266; and Monica Langley, ''Fidelity Gift Fund Soars, but the IRS Is Skeptical,'' *The Wall Street Journal*, Feb. 12, 1998.

[21]*See* Vanguard Charitable, ''History of Vanguard Charitable,'' *available at* https://www.vanguardcharitable.org/who_we_are/history.

[22]Schwab Charitable, ''About Schwab Charitable,'' *available at* http://www.schwabcharitable.org/public/charitable/about_schwab_charitable.

[23]*See* Michael J. Hussey, ''Avoiding Misuse of Donor Advised Funds,'' 58 *Clev. St. L. Rev*. 59, 63 (2010); and Madoff, *supra* note 20, at 1266.

[24]Indeed, some of the issues may be worse for a community foundation since the investment fees are less transparent.

[25]All data in the charts come from the sponsoring organizations' Forms 990, *available at* http://www.guidestar.org.

[26]*See* Langley, *supra* note 20 (discussing IRS audits).

[27]Treasury, ''General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals'' (2000), at 107.

[28]PPA section 1231-1235 (codified at sections 4943, 4958, 4966, and 4967).

[29]The sponsoring organization cannot be a veterans organization, fraternal society, or cemetery corporation, nor can it be a Type III supporting organization unless it is a functionally integrated Type III supporting organization. Section 170(f)(18)(A). *See* PPA section 1234.

[30]Section 170(f)(18)(B).

[31]PPA section 1266. The IRS issued Notice 2007-21, 2007-1 C.B. 611, requesting public comment on these issues.

[32]Treasury, ''Report to Congress on Supporting Organizations and Donor Advised Funds'' (Dec. 2011), at 6-7.

[33]*Id.* at 83.

[34]*See, e.g.*, Hussey, *supra* note 23, at 74; Madoff, *supra* note 20, at 1265; New York State Bar Association Tax Section, ''Report Responding to Notice 2007-21 Concerning Donor-Advised Funds and Support Organizations'' (June 6, 2007), at 13-14; Alan Cantor, ''Donor-Advised Funds Let Wall Street Steer Charitable Donations,'' *Chron. Philanthropy*, Oct. 28, 2014; and Madoff, ''5

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The implication is that DAFs hurt charities by accumulating assets instead of distributing them, while taxpayers and sponsoring organizations benefit. I share the concern about the harm to charities, but as I show below, donors themselves are also hurt through tax costs and high fees. If, despite this, donors are still attracted to DAFs it must be because either the nontax benefits are worth the cost or there is a misunderstanding of the tax benefits.

III. The Claimed Tax Benefits of DAFs

In this section I review some of the particular tax benefits claimed for DAF donations. I focus on issues particular to DAFs, especially where there is a timing difference between the contribution to the DAF and the ultimate distribution to an operating charity. There are many other tax advantages to donating property to charity — DAF or operating charity — but I set those aside.[35] Similarly, I hold constant the year of ultimate distribution to an operating charity — I thus compare making a current contribution to a DAF today to fund a future distribution with simply waiting and giving directly at the future date. If the DAF actually changes the timing of the ultimate distribution — for example, because a donor would have donated sooner to an operating charity otherwise — that would be a concern for philanthropy.[36] However, as I show below, it's unlikely that a donor gets a tax benefit from delaying the ultimate distribution out of a DAF.

A. Accelerated Deduction

The essential tax policy concern is that donors are getting an immediate and large deduction for amounts that will go to an operating charity only later, or perhaps never. But in fact there is no tax benefit from accelerating the deduction because the law permits the donor to donate appreciated property directly to a charity without realizing any potential capital gain.[37] Thus, if a donor simply saves the money himself — perhaps in an LLC named for himself and his spouse[38] — and donates appreciated property later, he will get a larger deduction, the value of which will have grown tax-free. (I ignore for now any annually taxed income, such as interest or dividends.) Moreover, in many cases there may be an additional tax cost to the immediate contribution to the DAF because the tax savings from the contribution may be reinvested, and the reinvested funds my generate income subject to tax.

Suppose I have appreciated property worth $100 that I would like to use to fund a donation to a charity next year. I expect that property to appreciate 10 percent between now and then. (Or equivalently, I have $100 in cash that will be invested in the same portfolio, whether in a DAF or in my own taxable account.) If I contribute the money now to a DAF, I get a $100 deduction, which, if I'm in the 40 percent bracket, is worth $40 to me. Next year, when the asset will be worth $110, the DAF will distribute the proceeds to the charity. Meanwhile, the $40 value of the deduction, if invested in a similar portfolio, will have grown to $44.

If instead I simply hold the asset, it will be worth $110 to me next year. When I donate it directly to the charity,[39] I will get a $110 deduction, which will be worth $44 to me. And of course, I avoid taxes on any appreciation in the asset. Thus, in both cases, next year the charity gets $110, and I get $44.

Indeed, I may actually be worse off in the DAF case because the $4 growth is taxable, leaving me with only $43.20 if I were to convert it to cash that year (assuming a 20 percent tax on capital gains). But in the direct donation case, I get the full $44 (see Table 1). If I hold the asset myself, the value of the deduction grows at a pretax rate of return, whereas if I give the asset to a DAF, the value of the deduction grows at an after-tax rate of return. Essentially, direct ownership of appreciating assets intended to be given to charity later is a better DAF than the DAF itself.[40]

Myths About Payout Rules for Donor-Advised Funds," *Chron. Philanthropy*, Jan. 13, 2014. Another set of concerns relates to the ability of donors to exercise a degree of control that could lead to private benefit even though they have no legal control. *See, e.g.*, NYSBA, *supra* at 21-29. This is less of a concern following the PPA. Further, private benefits of this sort are unlikely to occur for DAFs controlled by the major commercial gift funds. Thus, I assume here that the issues are largely ones of timing and fees, not private benefit.

[35]For example, I don't discuss estate tax issues, because a DAF is just one possible way to get assets out of an estate.

[36]*See* Brian Galle, "Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy," 92 *Wash L. Rev.* ___ (coming 2016).

[37]The issues discussed here could also apply to donations of publicly traded stock to a private foundation. *See* section 170(b)(1) and (e)(5).

[38]*See* John Cassidy, "Mark Zuckerberg and the Rise of Philanthrocapitalism," newyorker.com (Dec. 2, 2015) (discussing the Chan Zuckerberg Initiative).

[39]This of course assumes that the charity can accept noncash donations, including non-publicly traded stock. But even if the charity won't accept them, the donor could simply use a DAF as a conduit, which is totally reasonable. The donor could give the assets to a DAF in the later year and then immediately advise the sponsoring organizations to sell the asset and distribute the proceeds. *See infra* Section III.F. But that is a separate question from whether a donor should have the DAF hold and accumulate assets for a period.

[40]Algebraically, the tax benefit of giving to a DAF this year is worth:

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Table 1. Accelerated Deduction Example		
	Give to DAF This Year	Give to Charity Next Year
Y1 starting cash balance	$100	$100
Y1 gift	$100	$0
Value of Y1 tax deduction	$40	$0
Y2 funds for charity	$110	$110
Y2 gift to operating charity	$110 (from DAF)	$110 (direct)
Value of Y2 tax deduction	$0	$44
Y2 cash balance	$44	$44
Y2 after-tax cash balance	$43.20	$44

We get a similar result if the donor grosses up the donation by the amount of the deduction.[41]

Even if the taxpayer doesn't get an extra benefit from the immediate deduction, is the fisc somehow hurt by allowing it? Unlikely. If the government grants a deduction for the gift to the DAF this year, it lowers its own tax revenue for the year by $40. The argument for incurring this tax expenditure (leaving aside distributional issues) is that it amounts to a subsidy for charitable giving to encourage private spending on public goods. But if no charity is actually occurring in the year of the gift, is that a tax expenditure well spent?

Suppose the government has to borrow money for one year to make up the $40 shortfall. It borrows at some rate well below the 10 percent return that the asset earns — let's say 2 percent. Next year it will repay the lender $40.80. But next year there will be an additional $44 in tax revenue because $110 of taxable income goes unsheltered (because the donor gave $100 this year instead of $110 next year). So the government makes a profit — it essentially borrows at 2 percent to lend at 10 percent by accelerating the deduction one year, in addition to the extra 80 cents it earns from the growth in the $40 deduction.[42]

Table 2. Government Revenue		
	Give to DAF This Year	Give to Charity Next Year
Y1 tax revenue	$0	$40
Y1 borrowing	$40	$0
Y1 interest expense	$.80	$0
Y2 tax revenue	$44	$0
Y2 bond repayment	$40.80	$0
Y2 net cash	$43.20	$40

Under these assumptions, therefore, the government actually increases revenue, in present-value terms, from encouraging earlier donations to DAFs.[43] This may be one reason the Treasury report

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$$(1) \qquad t_mC(1+r)^n - t_c\,[t_mC(1+r)^n - t_mC]$$

in year n, where C is the amount of the contribution, t_m is the marginal tax rate, t_c is the capital gains tax rate, and r is the market rate of return. This reduces to:

$$(2) \qquad t_mC\{(1+r)^n - t_c\,[(1+r)^n - 1]\}$$

In contrast, giving directly to charity in year n is worth:

$$(3) \qquad t_mC(1+r)^n$$

Thus, as long as t_c and r are both positive, giving later is better. The capital gains rate may be zero, however, if the donor plans to give away the future proceeds of the current deduction as another charitable contribution in a future year, or if the donor dies and the basis of the assets purchased with the deduction is stepped up to fair market value at death.

[41]With grossing up, we would just divide equations (1) and (3) by $(1 - t_m)$, so the same comparison between (2) and (3) holds. The intuition for why (3) is still better than (2), even though the donor essentially invests the value of the deduction in the DAF, is that the donor in the DAF case ought to gross up only by the present value of the deduction, which as shown in (2), is not 100 percent of the nominal deduction because there will be some tax cost as it grows (see also *infra* Equation (6)). If the donor grossed up by the full value of the deduction in year 1, she would still have some tax cost in year 2 from the growth in that larger deduction and so would have essentially grossed up by too much.

[42]In other words, the present value of the lost revenue as a result of a future deduction to a charity is greater than the present value of a deduction to a DAF today. The government revenue loss from a contribution C today is simply t_mC. But the present value of the future deduction of C is:

$$(4) \qquad \frac{t_mC(1+r_m)^n}{(1+r_g)^n}$$

where r_m is the market rate of return and r_g is the government's borrowing costs. As long as $r_m > r_g$, this amount will be bigger in present-value terms than the current deduction.

Key to this result is using the government's borrowing rate as the discount rate, rather than a market rate of return. While government budgeting uses the government's borrowing rate, some argue that fair-value accounting, *i.e.*, using a market discount rate, would be a better approach. *See, e.g.*, Congressional Budget Office, "Fair-Value Estimates of the Cost of Selected Federal Credit Programs for 2015 to 2024" (May 2014), at 1-4; and Jason Delisle and Jason Richwine, "The Case for Fair-Value Accounting," *Nat'l Affairs* 95 (Fall 2014). My view is that fair-value accounting would not be an improvement over the current accounting rules. *See, e.g.*, David Kamin, "Risky Returns: Accounting for Risk in the Federal Budget," 88 *Ind. L.J.* 723 (2013) (arguing against the fair-value method and risk adjustment generally in federal budgeting).

[43]Note that the return on the tax revenue itself is irrelevant. Having $40 in revenue could allow the government to invest in productive projects that could produce a return (*e.g.*, research and development that increases tax revenue). But in my example, the government has that $40 in year 1 in either case — in

(Footnote continued on next page.)

comes down relatively lightly on DAFs.[44] Of course, the government should not care simply about revenue maximization, but about whether the use of DAFs causes less revenue loss than later direct gifts — that may be one reason for the government not to crack down too hard. On the other side of the ledger, however, is the bigger question whether DAFs actually lead to smaller future gifts in practice because of poor investment management, high fees, and private benefits.

B. Tax-Free Growth

In the example above, I assumed that all the return from the assets used to fund the donation is in the form of capital gain. Because capital gain can be avoided simply by donating the appreciated asset, there is nothing to be gained from using a DAF only to avoid taxes on that growth. However, the return from an asset can also take the form of annually taxed items of income, such as interest, dividends, and for mutual funds, capital gains distributions.[45] Also, if the asset in question is a diversified portfolio, there may be capital gain realizations when rebalancing between asset classes.[46] If the assets produce a lot of that annually taxed income, there is a tax benefit from holding them in a DAF. As a tax-exempt organization, the DAF sponsoring organization would not have to pay any tax on those items of capital gain income, and therefore, more could be reinvested, generating more funds for later disbursement to an operating charity. Brian Galle has thus described the value of donating to a private foundation as essentially avoiding the lock-in effect from holding a portfolio in a taxable account.[47]

This real tax benefit may in some circumstances be very valuable. Bonds, real estate, and stock of closely held businesses, for example, may produce much of their return in the form of annually taxed cash flows rather than appreciation. Similarly, a company founder or executive may be overly concentrated in that company's stock and wish to diversify, thus triggering capital gain. But the more likely case is donors simply donating stock or mutual fund shares out of their portfolios, or even just cash.[48] For example, Treasury found that in 2005 nearly 96 percent of all noncash contributions were either corporate stock or mutual funds.[49]

If that's the case, the benefits from tax-free growth are more limited. First, a well-managed portfolio can often avoid much of these tax costs through, for example, holding more growth stock, aggressive loss harvesting, or the strategic use of other tax-preferred plans like section 401(k) plans, IRAs, and section 529 plans.

Second, any tax benefit needs to be weighed against other costs of holding assets in a DAF. By some estimates, the tax drag on a typical equity mutual fund is somewhere between 0.27 percent and 1.2 percent.[50] The low end is for the relatively few tax-managed mutual funds, and the high end is for actively managed funds. Equity index funds are in the middle, with a tax drag of around 0.77 percent.[51] But that is awfully close to the 0.6 percent fee that most of the commercial gift funds charge, in addition to the fees for the underlying funds.

Holding an actively managed mutual fund in a DAF may provide better after-tax, after-fee growth than holding that fund outside a DAF, but that is a function of poor tax management by active fund managers. If a well-managed portfolio faces a tax burden more like 0.27 percent — the estimate for tax-managed funds — the donor would be worse off in holding that portfolio or fund in a DAF. In that case, the DAF sponsoring organization captures all the tax benefit from the tax-free growth — and then some. In essence, all taxpayers pay the fee for the simplification and centralization benefits that the DAF provides, with little burden on the donor herself. The tax benefit from having a tax-exempt organization manage the portfolio accrues to the investment managers, not to the donors or charities.

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one case, it's from tax revenue, and in the other, it's from borrowing. Thus, the only factor is the cost of borrowing, not the return on the cash.

[44] *See supra* text accompanying notes 31-32.

[45] This could also include rents, royalties, and other forms of periodic income from property.

[46] Or alternatively, there is a lock-in cost to holding assets in a taxable portfolio if the taxpayers avoid rebalancing so as not to trigger gain.

[47] Galle, *supra* note 36.

[48] According to Fidelity's website, 62 percent of the donations in 2013 were in the form of appreciated securities (*available at* http://www.fidelitycharitable.org/giving-strategies/tax-estate-planning/appreciated-securities.shtml). It's unclear what the breakdown is in the remaining 38 percent among cash, real estate, partnership interests, and other forms of property.

[49] *See* Treasury, *supra* note 32, at 61.

[50] *See, e.g.*, Clemens Sialm and Hanjiang Zhang, "Tax-Efficient Asset Management: Evidence From Equity Mutual Funds," National Bureau of Economic Research working paper 21060 (Apr. 2015), at 34 (also finding that tax-efficient management does not reduce pretax performance); *see also* James Daniel Bergstresser and James Poterba, "Do After-Tax Returns Affect Mutual Fund Inflows?" 63 *J. Fin. Econ.* 381, 389-390 (2002) (finding tax burdens of between 0.9 percent and 4.7 percent but that during the 1993-1999 period when equity returns were very high, the mean pretax return on equity mutual funds was 19.1 percent).

[51] *See* Sialm and Zhang, *supra* note 50.

C. Lumpy Income and Bracket Shifting

The above sections describe the tax treatment of contributions to a DAF in the typical case, but some of the tax planning of DAFs involves atypical periods of lumpy income. In some of these cases, DAFs may provide an additional tax benefit. A spike in income can have two effects. First, it can push income that would otherwise have been in a lower bracket into a higher bracket. A donation in that year would thus be more valuable. Second, higher income in one year can allow for a higher donation cap under the percentage limitations of section 170(b).

1. Bracket shifting. Lumping a donation into a high-bracket year provides a real tax benefit if the assets are not held in the DAF for too long after the contribution. If they are held too long, the tax on the growth in value of the immediate deduction erodes any benefit from the bracket shift. Consider the same $100 gift as above. This year the marginal tax rate that would apply is 40 percent, but next year it is 35 percent. The results are shown in Table 3A.

Table 3A. Shifting Brackets — One Year

	Give to DAF This Year	Give to Charity Next Year
Y1 starting cash balance	$100	$100
Y1 gift	$100	$0
Value of Y1 tax deduction	$40	$0
Y2 funds for charity	$110	$110
Y2 gift to operating charity	$110 (from DAF)	$110 (direct)
Value of Y2 tax deduction	$0	$38.50
Y2 cash balance	$44	$38.50
Y2 after-tax cash balance	$43.20	$38.50

The savings thus amount to $4.70, or $4.27 in present value, rather than the $5 that might be expected based on the 5 percent spread in tax rates. And those savings will shrink as the time between the current year and the ultimate disbursement elapses. Consider Table 3B, in which the ultimate distribution is two years, rather than one, after the DAF contribution.

Here the savings are $4.37, or just $3.61 in present value. The present value of the pretax savings at the end is always $5, but because the additional tax on the earnings from investing the original $40 deduction also grows — whereas the growth is completed untaxed when giving directly later — the after-tax value of giving early declines the longer the gap between the DAF gift and the ultimate distribution to an operating charity. Indeed, under these assumptions, the value of giving later exceeds the present value of giving today if the funds are actually distributed to an operating charity 11 years or more after the current period, even if the donor is in the lower bracket in the future.[52]

Table 3B. Shifting Brackets — Two Years

	Give to DAF This Year	Give to Charity In 2 Years
Y1 starting cash balance	$100	$100
Y1 gift	$100	$0
Value of Y1 tax deduction	$40	$0
Y3 funds for charity	$121	$121
Y3 gift to operating charity	$121 (from DAF)	$121 (direct)
Value of Y3 tax deduction	$0	$42.35
Y3 cash balance	$48.40	$42.35
Y3 after-tax cash balance	$46.72	$42.35

This analyis assumes that donors can actually get themselves down a bracket. It's ultimately an empirical question how often that occurs, and there appear to be no publicly available data on the characteristics of DAF donors. My assumption, however, is that most of the individuals and couples

[52]Algebraically, suppose that t_M is the higher marginal tax rate that will apply this year, and t_m is the lower marginal rate that will apply in some future year n. As before, r is the market growth rate. Taking Equation (2) and discounting it to the present period with discount rate r, the present value of the DAF gift today is:

$$\frac{t_M C\,\{(1+r)^n - t_c\,[(1+r)^n - 1]\}}{(1+r)^n} \tag{5}$$

or:

$$t_M C\left(1 - t_c\left(1 - \frac{1}{(1+r)^n}\right)\right) \tag{6}$$

By contrast, the present value of giving directly to a charity in year n with the lower marginal rate is:

$$\frac{t_m C\,(1+r)^n}{(1+r)^n} \tag{7}$$

or simply $t_m C$. If we set $t_M = t_m + \gamma$, this becomes $t_M C - \gamma C$. Comparing this to Equation (6), a donor should give to a DAF in the current year when:

$$\gamma > t_c C_M\left(1 - \frac{1}{(1+r)^n}\right) \tag{8}$$

As n and r get bigger, the right side of the inequality gets bigger, so if n and r are high enough, the inequality will no longer hold. Solving for this with $\gamma = 0.05$, $t_M = 0.4$, $t_c = 0.2$, and $r = 0.1$ gives us $n < 10.29$. For n larger than that, the donor is better off waiting and donating at time n, even though the donor may be in the 35 percent bracket at that time. Different assumptions will of course yield different results.

donating the large amounts that would matter are unlikely to get down a bracket. Of the $182 million in reported deductions for all charitable contributions in 2013 (not just to DAFs), about one-third were from households with AGIs of $500,000 or higher and of the $48 million in reported noncash contributions, more than half were from households with AGIs of $500,000 or more.[53] It's likely that DAF donors skew even more toward those in the highest bracket.

2. Section 170(b) percentage limitations. The other atypical situation in which a DAF may be beneficial is when the donor is otherwise confronting the section 170(b) percentage limitations. This might be because the donor normally has relatively low income but faces a one-time spike and thus has the ability to deduct much more in that year.[54] If a donor who normally has AGI of $100,000 a year (and thus can take a deduction for only up to $50,000 annually) has one-time income of $1 million, she could give $500,000 in cash that year and get a full deduction.[55] However, because, as shown in Section III.A, the timing of the deduction doesn't matter, this would be relevant only when the donor would otherwise face some lifetime giving cap, not merely an annual cap. If the donor wanted to max out her donations every year, giving more in a lumpy year would increase the total lifetime deduction. But if it only accelerated giving that would otherwise occur in later years, there's no real benefit. Furthermore, there's nothing special about DAFs in this regard, except as a place to park money in the lumpy years if the donor wanted to smooth contributions over the years — the donor could simply give the larger amounts directly to charity.

More specific to DAFs is that the sponsoring organizations are public charities, and thus donors can give up to 50 percent of their AGI for cash but only 30 percent for capital gain property. In Section III.A, I said that the donor could achieve even better results than a DAF by just investing the property himself. That was assuming the desired asset was capital gain property and that the donor was not facing the 30 percent limitation. But if the donor would like to donate cash exceeding 30 percent of his AGI, he would need to do it immediately. If instead he invested it in a personal portfolio, his donation in future years would be capped at 30 percent rather than 50 percent of AGI, unless he realized any gains in the portfolio. As above, if a wealthy donor wants to maximize lifetime giving, he may be better off donating at least some of that cash to a DAF.[56] Again, however, this benefit is not unique to a DAF — the donor could get the same result donating directly to an operating charity. Rather, the DAF provides a simplified way to set aside that money when the donor hasn't decided on ultimate charities or would otherwise like to have relatively smooth giving over the years.

D. Forced Realizations

DAFs also provide some tax benefit when the donor would be forced to realize a gain anyway. Perhaps the donor will be selling stock in an initial public offering or a buyout, the underlying company is redeeming shares, or the donor has to divest itself of particular assets because of government service or a similar conflict of interest. If a donor can meet his charitable goals by donating assets that he would otherwise have to sell, he clearly comes out ahead compared with just giving cash.

That said, he could achieve the same tax benefit by donating directly to operating charities, perhaps in a restricted way to align with his desired distribution schedule. However, if the donor wanted to give to multiple charities over multiple years, doing so with assets that would otherwise be sold this year could be quite complicated. In that case, a DAF may provide some simplification benefit, although at a cost. On the other hand, for some donors, such as small business owners, giving to a DAF also means giving up control. Although the sponsoring organizations market DAFs as mini-private-foundations, they are in fact independent entities completely separate from the donors and make no promises about either investment strategy or ultimate distributions.[57] A company founder who hopes to still exert some control while also avoiding capital gain and receiving a deduction should use the private foundation form instead.

E. Donating at Peak Value

Suppose that you plan a deduction for next year, but you believe the market is at a high point this year — so it would make sense to try to use stocks to maximize the value of that deduction this year, even though you plan for the actual gift to be next year. Leaving aside that trying to time the market is

[53]IRS Statistics of Income, "2013 Individual Income Tax Returns," at 97, Table 2.1, *available at* https://www.irs.gov/pub/irs-soi/13inalcr.pdf.

[54]This is a version of the common advice to company founders to establish private foundations in the year of the company's initial public offering.

[55]Ignoring the issue of bracket shifting, discussed *supra*.

[56]To get maximum flexibility, the donor may donate 30 percent of his AGI to a private foundation and the remaining 20 percent to a DAF.

[57]Fidelity Charitable's website states that it will sell any contributed, non-publicly traded assets at its discretion, *available at* http://www.fidelitycharitable.org/giving-account/what-you-can-donate.shtml.

a fool's game, this tactic may generate some tax benefit, but not in the way one might think. Continuing with our same example of a $100 donation this year to a DAF or next year to an operating charity, let's now assume that the market will drop in value by 10 percent rather than increase.

Table 4. Donating at Market Peak

	Give to DAF This Year	Give to Charity Next Year
Y1 starting cash balance	$100	$100
Y1 gift	$100	$0
Value of Y1 tax deduction	$40	$0
Y2 funds for charity	$90	$90
Y2 gift to operating charity	$90 (from DAF)	$90 (direct)
Value of Y2 tax deduction	$0	$36
Y2 cash balance	$36	$36
Y2 after-tax cash balance	$36.80	$36

In both cases, the charity gets $90, so making the donation today does not preserve the value of the contribution, assuming it's invested in a market portfolio. Further, giving away the asset at peak value doesn't necessarily lock in a high value for the deduction in present value terms because it still needs to be parked somewhere, and in a market portfolio, it faces the same risk as before. But the donor could get a small tax benefit from realizing the loss from investing the proceeds of the tax deduction, leaving her with more after-tax cash compared with giving directly to the charity next year.[58] The intuition is that by getting the value of the deduction now, she will later be able to realize a tax loss on the value of that deduction, whereas if she held the property and later gave it directly, no losses would be realized.[59] To achieve this result, however, she would have to have some offsetting gains.

The situation is different for a unique asset, rather than a market portfolio. Company founders and executives, for example, may be privy to insider knowledge that the value of their company's stock will fall in the future. If that company's stock is not correlated with the market, donating to a DAF today to get the higher deduction value versus waiting may create a real benefit. The deduction would be at its peak value and then would be invested in a market portfolio that could grow even as the original asset declined in value. For example, David Yermack has shown that the chairs and CEOs of public companies tend to make large donations of their company's stock to their private foundations right before a sharp decline in the company's share price.[60] But the donor could retain control in the private foundation context; that's less likely to be the case with a DAF. Thus, the donor would again have to balance the value of getting a higher deduction today with losing control of the underlying asset.[61]

F. Nontax Benefits

DAFs are not without some benefits — they are just not primarily tax benefits. The main advantage of DAFs is that they provide a simple and convenient way to fund contributions to operating charities with appreciated property. For example, if a donor wished to donate to five charities in five equal amounts using appreciated property, she would have to divvy up the property among the five charities (assuming they were even able to receive property). A single donation to Fidelity, followed by advice on how to distribute the proceeds, could be much simpler.

But this means treating the DAF simply as a conduit for the donation of appreciated property — there really would be no fund to speak of. Furthermore, although it might be difficult for a donor to make the five donations of appreciated property herself, for those with investment managers or financial advisers, direct donations may be just as simple as donations to a DAF — they just need to tell their adviser to transfer the appropriate amounts to the charities' custodial accounts and let him do the math.

Similarly, DAFs may simplify donations of non-publicly traded assets. Many operating charities, especially smaller ones, are not set up to handle, for example, hedge fund or private equity partnership interests. But the commercial gift funds make very clear that they will take anything. Again, however, this is not a tax-specific issue — presumably large and sophisticated charities would be happy to take the assets directly.

But even if there is some convenience and flexibility from using the DAF as a conduit for gifts of

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[58]This is just a straight application of Equation (2), when a negative r increases the value of giving to a DAF today rather than giving to an operating charity next year.

[59]I'm assuming here that the donor would still have some appreciated gain in the asset even after the drop in value, so she would still prefer to give the asset directly. If, however, she had a high basis, she would instead realize the loss, and the above example wouldn't apply.

[60]David Yermack, "*Deductio Ad Absurdum*," 94 *J. Fin. Econ.* 107 (2009).

[61]*See supra* Section III.D.

property, what about the fund part? Why use a DAF to set aside assets to fund later contributions? As I've already shown above, there is little tax benefit to establishing a fund, and there is perhaps a tax cost for many donors. I think this fact is not appreciated by most donors. But could there be nontax benefits? In my view there must be some personal or psychological value to having something with the trappings of a private foundation, but without the hassle and with better tax treatment. But that would be based on the fundamental fiction that the DAF remains the donor's. A donor may imagine that the DAF would create a legacy that would, for example, provide some family unity or philanthropic role after the donor's death, much like if the family sat on the board of a private foundation.[62] But in reality, it is a pale imitation with much less control over investment strategy, foundation management, or even charitable distributions. Being able to call a bookkeeping entry at Fidelity Charitable the ''John R. Brooks Foundation'' may seem nice, but it is ultimately an expensive form of vanity.

IV. Conclusion

Commentary on DAFs generally concludes that they may be a problem for philanthropy. The huge volume of gifts flowing to, and the accumulated assets of, the commercial gift funds imply a lot of money staying on the sidelines rather than supporting the very real charitable needs of society. Furthermore, the more the money stays on the sidelines, the more it gets sucked away as fees for investment managers. The typical reform proposal is to require some minimum payout rate for DAFs to ensure that the contributions to the funds flow out relatively quickly to operating charities. I share those concerns and generally support those proposals.

However, I also find in this report that the concerns about DAFs from a tax policy perspective may be overblown. For most donors most of the time, there is no substantial tax benefit to donating to a DAF, and there may even be a tax cost. Contrary to conventional wisdom, many donors would be better off holding on to the assets they plan to use to fund gifts in future years rather than giving them to a DAF all at once today. Similarly, there is no real revenue loss to the government in present value terms for allowing a full deduction for contributions to a DAF. This may compound the underlying problem with DAFs, however, because the sponsoring organizations are really the only ones that get any real benefit.

This conclusion does not mean that there is no role for tax policy. If a misunderstanding of the tax benefits encourages excessive donations to DAFs and relatively slow payouts to operating charities, the tax law needs to respond. A first step, however, would be to inform potential donors that DAFs are not all that they seem.

(Figures appear on the following pages.)

[62]Although, importantly, a decedent's heirs do not necessarily get control. Vanguard Charitable, for example, states that DAFs without a specific succession plan will automatically be transferred to the general fund, which Vanguard Charitable uses at its sole discretion (*available at* https://www.vanguardcharitable.org/individuals/leave_legacy).

Figure 1. DAF Contributions

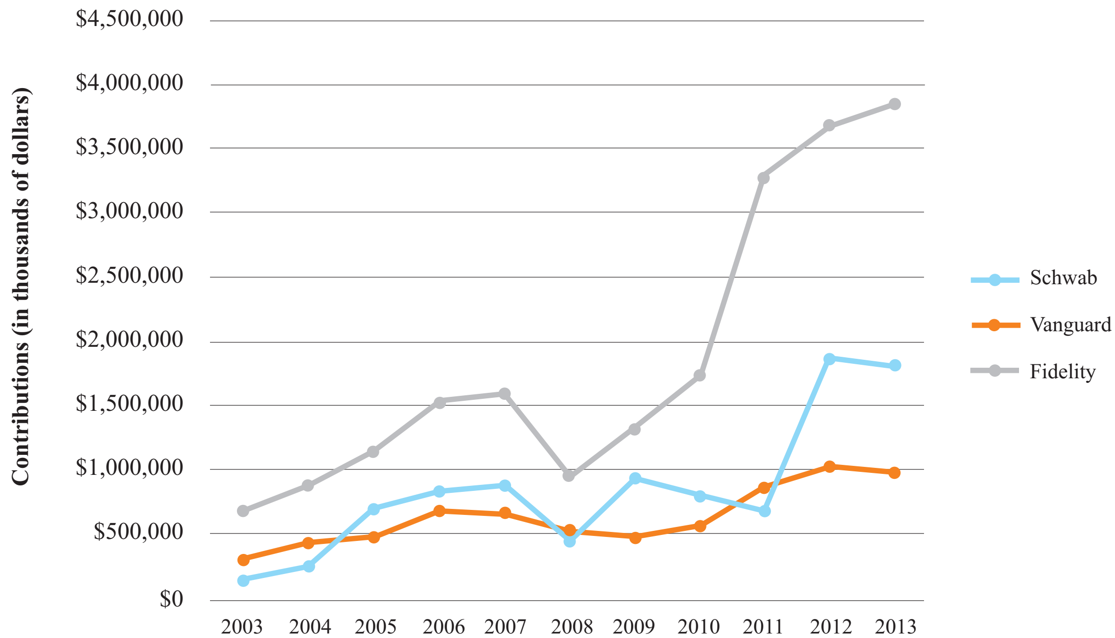

Figure 2. DAF Distributions

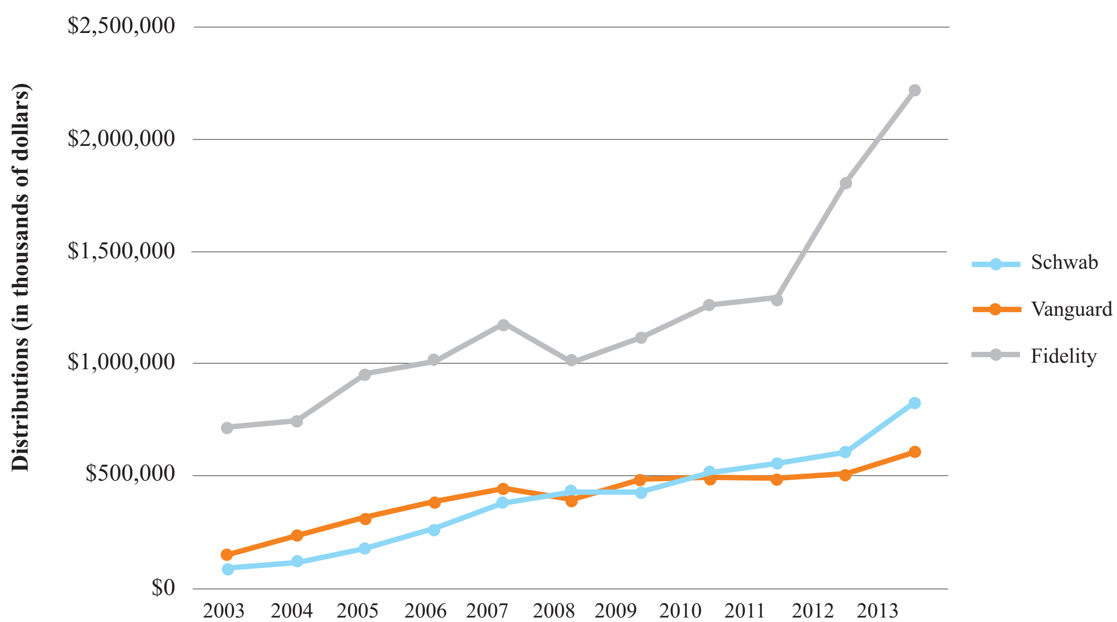

Figure 3. DAF Total Assets

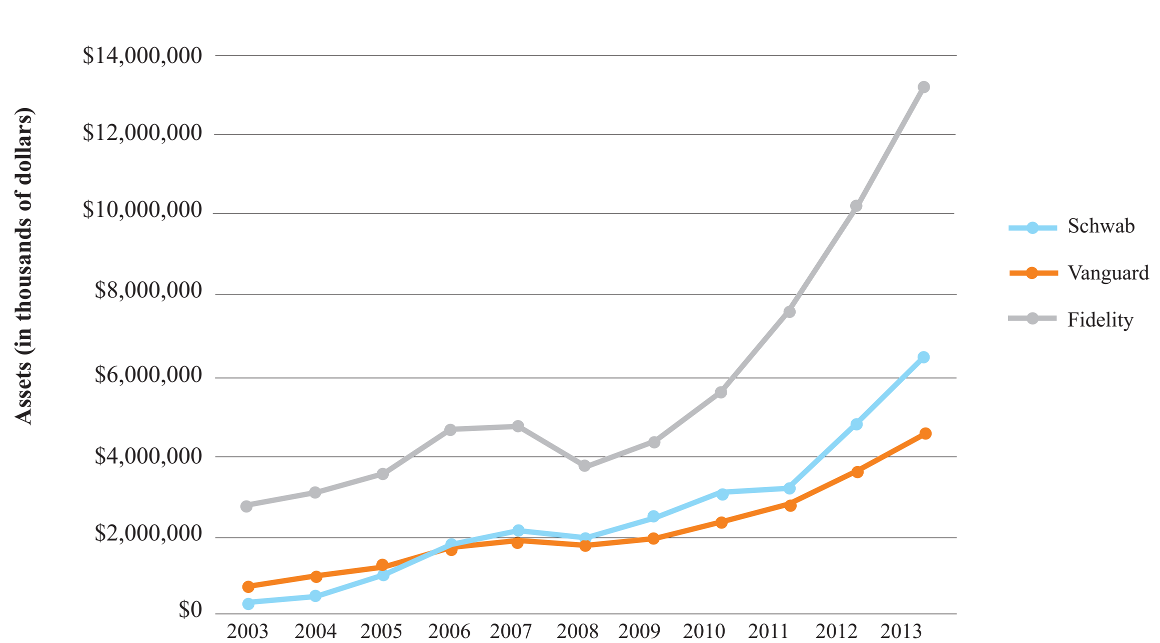

Figure 4. DAF Annual Return