NONPROFITS: INTERNAL REVENUE SERVICE

Donor-Advised Funds: New Reform Proposal

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Donor-advised funds (DAFs) have enjoyed spectacular success in recent years, and the most current data show this trend not only continuing but accelerating.

But along with this popularity has come considerable criticism from many quarters as well as attempts by federal and state lawmakers to regulate them.

Recently, two of the philanthropy sector's leading scholars, Professors Roger Colinvaux (Catholic University of America) and Ray D. Madoff (Boston University) published *A Donor-Advised Fund Proposal That Would Work for Everyone* (September 23, 2019) in the Chronicle of Philanthropy.

This is *not* part of a proposed comprehensive overhaul of the 501(c)(3) rules – and in particular, the provisions relating to private foundations and deductibility of charitable contributions. Many public policy and law experts in philanthropy, academia, and government including Professors Colinvaux and Madoff prefer a bigger solution. But these laws have not been fully revamped since the Tax Reform Act of 1969 which first introduced substantial regulation of private foundations, and this type of major legislative action is a non-starter in the current political climate.

Nor is it these scholars' first proposal for donor-advised fund reform. They have "long been concerned that the tax rules are not working as they should to get money to charities," and earlier argued that imposing a "payout term to ensure that DAF funds are distributed within a reasonable amount of time – say, a decade" could be a workable compromise in the short run. They continue to believe that "… a payout is one solution," but *not the only one*, particularly after continuing review of the issue and hearing feedback from donor-advised fund sponsors.

The new proposal, they write, "… is an even better approach that could maximize contributions, help donors save on taxes, and avoid abuses that lose money for the Treasury."

Happily, these distinguished academics have presented their concept in a remarkably easy-to-read, plain-English, article. That – alone – is cause for calling it your attention.

The Donor-Advised Fund Problem

In a nutshell, the problem is that "… the dollars are flooding into DAFs …but… too few dollars are coming out." Why? It's … "because the legal framework

governing these funds is out of sync with the way tax incentives are supposed to work." The federal tax code, ideally, should establish enticements to prod citizens to "… take an action deemed good for society, in this case, to make funds available so that charities can use them in support of their mission." The problem is that this "… system is backwards: the federal government provides donors huge tax subsidies upfront, handing them out when the donor sets up a funds or augments it, but there is no incentive to actually give the money away."

The Donor-Advised Fund Solution

The proposal by Professors Colinvaux and Madoff is to "split the tax benefit into two parts"; donors are given part of the tax break when money goes into the DAF and the rest is triggered when and as they direct the sponsor to move money to one or more designated charities.

Their plan is predicated on the notion that any change should take into account and "reflect the reality of donor-advised funds" and be fashioned to get the tax code back into sync with the real world. The paragraphs in the middle of the article are particularly clear about how DAFs work, concluding with a pithy summary that contains excellent shade. "DAF funds are held in a netherworld:" they write. "The donor has given up legal title so cannot use the funds to buy a yacht or for other personal purposes. But the DAF money is not truly available for charitable use until a donor says so."

The authors' explanation includes how this proposal takes into account the fact that many taxpayers who set up DAFs transfer non-cash assets including stock or real estate that have increased in value. There are specific tax benefits that accrue to this type of donation including the avoidance of capital-gains or estate taxes; any reform proposal should consider this feature.

Benefits of New DAF Proposal

One of the benefits of the new Colinvaux-Madoff proposal, and why "it's good for charities" is because it counters "… the subtle incentives to hoard assets" embedded in the current system. "DAF sponsors and donors' financial advisers (who are often paid fees based on the amount of funds in the DAF) all profit when funds are retained in the DAF instead of being transferred to charity." They also explain a concept identified by behavioral economists as "the endowment effect" that afflicts many "well-meaning DAF holders who hoard money in their donor-advised funds."

"What's more," they assert, "nothing would change about the other things that make donor-advised funds attractive: namely, (1) "efficiency by centralizing giving through a single account"; (2) ability to channel sudden financial windfalls to charity, even before a donor has a philanthropic

strategy set; and (3) ability to include "family members in giving."
In short, the proposal "…ties the charitable deduction to the behavior we all want to achieve – which is getting money to charity."

Conclusion
Reaction is coming in to this new idea from Roger Colinvaux and Ray Madoff, including at *Don't Delay Deductions for Gifts to Donor-Advised Funds* (October 7, 2019) by Kate Harris and Professor Daniel Hemel of the University of Chicago Law School.
We'll follow these developments.