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## Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy

Roger Colinvaux

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# DONOR ADVISED FUNDS: CHARITABLE SPENDING VEHICLES FOR 21ST CENTURY PHILANTHROPY

Roger Colinvaux\*

*Abstract:* The donor advised fund (DAF) is changing longstanding giving norms in United States philanthropy. DAF contributions now account for around 8.4% of giving by individuals in the U.S. Over half of those contributions go to national DAF sponsors that have relationships with large commercial investment firms like Fidelity, Vanguard, and Schwab. This Article seeks to advance the understanding of the donor advised fund and to address two of the main policy questions: whether to require a mandatory distribution of funds by DAFs and their sponsoring organizations and how to respond to the increased use of DAFs for noncash charitable contributions. Part I of the Article provides a brief overview of DAFs. Part II of the Article discusses the different ways DAFs are viewed—as quasi-private foundations, public charity substitutes, or as catalysts for new charitable giving. Each view suggests a different regulatory approach. Part III focuses distinctly on the national sponsoring organization and the reason for its section 501(c)(3) status. The Article argues that as an organization that fulfills its mission by spending, it is appropriate for policymakers to require each fund to spend down contributions over a range of years. Part IV of the Article examines the solicitation by DAF-sponsoring organizations of charitable contributions of property, including privately traded stock, real estate, fine art, collectibles, and publicly traded securities. The increasing use of DAFs for noncash contributions will accentuate the problems of current law, which include a deduction for unrealized appreciation, overvaluation of contributed property, uncertain benefits to charity, equity concerns, and enforcement. Part IV argues that if Congress intends to retain the subsidy for property contributions, DAFs present an opportunity to improve and lower the cost of the subsidy both by reducing the amount of unrealized appreciation that may be deducted and by basing the amount of the deduction for property contributions on the net benefit to charity.

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## INTRODUCTION

The donor advised fund (DAF) is a modern fundraising phenomenon. The idea is simple. A donor gives money to a sponsoring charity, takes a tax deduction, and retains the ability to advise how the donated funds will be distributed. The idea is so compelling that an astonishing five of the top eleven recipients for charitable gifts in the United States are sponsoring organizations of donor advised funds—with the Fidelity Charitable Gift Fund first in the nation, topping United Way for this honor in 2015.<sup>1</sup> There are over 1000 charities that sponsor more than 269,000 DAF accounts, holding over \$78 billion.<sup>2</sup> The money is pouring in, and likely will continue. In 2015, roughly 8.4% of all charitable giving by individuals went to donor advised funds,<sup>3</sup> for a total of \$22.26 billion.<sup>4</sup>

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1. The Schwab Charitable Fund is fourth, the Silicon Valley Community Foundation tenth, the National Christian Foundation ninth and the Vanguard Charitable Endowment Program eleventh. Peter Olsen Phillips & Brian O’Leary, *The 2016 Philanthropy 400*, CHRON. OF PHILANTHROPY (Oct. 27, 2016), <https://www.philanthropy.com/specialreport/philanthropy-400-a-new-no-1/111> [<https://perma.cc/GRZ4-FWJP>] (listing the top 400 charities, measured by amount of contributions received).

2. NAT’L PHILANTHROPIC TRUST, 2015 DONOR-ADVISED FUND REPORT, “MARKET OVERVIEW” (2016) [hereinafter NPT 2016 REPORT]. The data is for 2015. Over a two-year period, the number of DAF accounts has grown by 24% (from 217,000 to 269,000 accounts) and total asset value held in DAFs has grown by about 37% (from roughly \$57 billion to \$78 billion). NAT’L PHILANTHROPIC TRUST, 2014 DONOR-ADVISED FUND REPORT 3 (2014) [hereinafter NPT 2014 REPORT].

3. This percentage is determined by dividing total contributions (\$22.26 billion) by total individual giving for 2015 (\$264.58 billion), as reported by Giving USA. *See generally* NPT 2016 REPORT, *supra* note 2; GIVING USA 2016: ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2015, 67 [hereinafter GIVING USA REPORT FOR 2015]. Prior to its 2015 report, the National

The biggest and perhaps best-known DAF sponsors are national in scope and often affiliated with large investment firms (like Fidelity, Schwab, and Vanguard). The main activity of these national sponsoring organizations (or NSOs) is to sponsor DAFs. Other DAF sponsors are community foundations, which traditionally have a more local focus and use DAFs as one of many fund types. Still other sponsoring organizations are active charities like universities that use DAFs as a fundraising tool to advance a single issue or purpose.<sup>5</sup> DAFs of all kinds are popular with donors because they promise efficiency, convenience, and tax benefits.

Yet with success comes scrutiny. As DAFs' share of the charitable giving pie grows, questions arise. Are DAF contributions hurting other public charities, depriving active causes of much needed funds? Are DAFs substitutes for private foundations, and thus a loophole that avoids the private foundation anti-abuse rules? Are DAFs attracting funds that otherwise would have been privately consumed, and so a welcome source for new charitable gifts? Do DAFs represent a hoarding or stockpiling of funds with no use-by date?

These are all important questions and difficult to answer in a conceptual vacuum. The DAF debate is in a confused state, in part because there is no common understanding of what DAFs represent. DAF sponsoring organizations are called public charities but, as grant-making entities, seem more like private foundations. Further, because

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Philanthropic Trust reported DAF contributions as a percentage of all gifts to charity, or "total charitable giving," which was somewhat misleading. "Total charitable giving," as reported by Giving USA, does not represent new gifts to the charitable sector. Rather, "total charitable giving" measures all giving, including not only giving by individuals, but also by foundations, corporations, and by bequest. To understand DAF contributions as a share of charitable gifts, what matters is not DAF contributions as a percentage of "total charitable giving," as that number is typically used, but DAF contributions as a percentage of *new* giving, i.e., the percentage of all money flowing into the charitable sector for the first time that goes to a donor advised fund. Only this percentage will convey the significance of DAFs as a giving vehicle as compared to other choices donors have.

4. By comparison, in 2014, roughly 7.6% of all charitable giving by individuals went to donor advised funds, for a total of \$19.66 billion. NAT'L PHILANTHROPIC TRUST, 2015 DONOR-ADVISED FUND REPORT 4 (2015) [hereinafter NPT 2015 REPORT]. In 2013, roughly 7.2% of all charitable giving by individuals was to donor advised funds, for a total of \$17.28 billion. In 2012, DAFs received \$13.99 billion, and about \$10 billion five years before that (2007). *Id.* at 5.

5. The National Philanthropic Trust divides sponsors into three categories: national sponsors, community foundations, and single-issue sponsors. NPT 2016 Report, *supra* note 2, at 1. The Treasury Department offers a similar taxonomy. See DEP'T OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS 21 (2011) [hereinafter TREASURY REPORT] (noting that sponsoring organizations include "charitable organizations formed by financial institutions for the principal purpose of offering DAFs, community foundations, universities, [supporting organizations], and other tax-exempt organizations").

not all DAF sponsoring organizations are the same, it is hard to generalize. The difficulty in conceptualizing DAFs in turn leads to considerable uncertainty about whether policymakers should respond to their increased use.

This Article seeks to advance the understanding of the donor advised fund by providing an analytical framework for how to conceptualize DAFs, especially DAFs at national sponsoring organizations.<sup>6</sup> The Article addresses two of the main policy questions: whether to require a mandatory distribution of funds (a payout) by DAFs at NSOs, and how to respond to the increased use of DAFs for noncash charitable contributions.

Part I of the Article sets the stage with a general overview of donor advised funds, types of DAF sponsoring organizations, and their recent history through the rise of the NSO. Part II then discusses the different, sometimes overlapping ways DAFs are viewed—as quasi-private foundations, public charity substitutes, or as catalysts for new charitable giving—each of which presents a different regulatory model. Part III then focuses distinctly on the NSO and the reason for its section 501(c)(3) status. Part III argues that because NSOs fulfill their mission by spending, it is appropriate to require a payout at the fund level. Part IV then examines the active solicitation by sponsoring organizations (not just NSOs) of charitable contributions of property, including privately traded stock, real estate, fine art, collectibles, and publicly traded securities. Part IV argues that if Congress intends to retain the subsidy for property contributions, DAFs present an opportunity to improve and lower the cost of the subsidy both by reducing the amount of unrealized appreciation that may be deducted and by basing the amount of the deduction (for all property contributions) on the net benefit to charity.

At the outset, it is important to identify the federal interest in regulating DAFs. There is a clear federal interest in protecting against abuse of the charitable deduction. Because donors receive a charitable deduction for DAF contributions, the federal government has an interest in ensuring that the funds are not directed to private use.<sup>7</sup> In addition, the

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6. Donor advised funds at community foundations and single-issue sponsors merit separate consideration. One of the anomalies of current law is that donor advised funds are defined and regulated without regard to sponsor. DAFs, however, need not have uniform rules. Characteristics of sponsoring organizations may be such that different rules should apply. Important definitional questions will need to be addressed when sponsoring organizations are distinguished.

7. Clearly, charitable giving that mainly benefits the donor is charitable in name only and should not be allowed, whatever the giving vehicle. As discussed in Part II, Congress has already adopted a number of anti-abuse rules in the DAF context. Additional anti-abuse rules could be extensive. For

government has a stake, not simply as a matter of taxation, but as a matter of the public interest, in helping ensure a reasonably efficient and equitable system of private charity. As measured by the huge sums pouring into DAFs, they clearly matter to the 501(c)(3) sector as a whole and to how charitable services are delivered in the U.S. Setting aside abuse, the challenge is to adopt an affirmative public policy toward donor advised funds, taking into account the unique characteristics of DAFs to determine how they should operate within the philanthropic system.

## I. DONOR ADVISED FUNDS AND SPONSORING ORGANIZATIONS, IN GENERAL

This Part provides an overview of the donor advised fund as a charitable giving vehicle, a description of the types of DAF sponsors, and a snapshot of legal issues related to the modern development of the national sponsoring organization.

### A. *The Donor Advised Fund*

Primarily, the DAF is a charitable fundraising device, a tool to persuade donors to part with money that will be used for charitable purposes. Some individuals considering a charitable gift might not be ready, or willing, to make a contribution. Ideally, and perhaps as originally conceived, the DAF is available for charities to persuade otherwise reluctant donors to give.

A DAF attracts donors because of the advice feature. After making a completed gift to a charity, a DAF permits donors to advise the charity on an ongoing basis about how to distribute fund assets for charitable purposes.<sup>8</sup> After the gift, the charity typically segregates donor funds into a separate account in the donor's name,<sup>9</sup> creating a vestige of ownership. The donor then may "advise" the charity about recipients, which must be other 501(c)(3) charities.<sup>10</sup> Thus, in a typical DAF transaction, the donor contributes to the DAF sponsor and takes a federal income tax deduction in Year 1.<sup>11</sup> Then, in a later year<sup>12</sup> the donor asks

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example, a payout rule not consistent with perpetuity could fit under an anti-abuse heading, where the abuse is defined as not making distributions quickly enough.

8. See generally MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RESEARCH SERV., AN ANALYSIS OF CHARITABLE GIVING AND DONOR ADVISED FUNDS 2 (2012).

9. See I.R.C. § 4966 (2012).

10. See *id.*

11. See I.R.C. § 170 (2012).

that the funds be paid to some other 501(c)(3), like Harvard University, Doctors Without Borders, the American Cancer Society, and so on.

Although the donor's advice typically is followed, the advice is not binding on the sponsoring charity (called a "sponsoring organization"),<sup>13</sup> which formally owns and controls the funds.<sup>14</sup> If formal legal control were not vested in the sponsoring organization, the gift would not be considered complete and would fail.<sup>15</sup>

In essence, DAFs offer a charitable contribution deduction for federal income tax purposes in the year of the gift, but allow the donor to retain power over the fund distribution.<sup>16</sup>

### B. DAF Sponsors

There are roughly three types of DAF sponsors: community foundations, NSOs, and single-issue sponsors.

Community foundations pioneered the DAF in the 1930s.<sup>17</sup> Community foundations historically existed to pool funds, often large gifts, for the benefit of a particular community.<sup>18</sup> In that context, it is

12. The advice also could occur in the same year.

13. I.R.C. § 4966 (2012).

14. See SHERLOCK & GRAVELLE, *supra* note 8, at 3 (noting that "[e]vidence suggests . . . that donors to DAFs have effective control over grants, and to some extent investments, because sponsoring organizations typically follow the donor's advice"); TREASURY REPORT *supra* note 5, at 69 (noting that one respondent thought that DAFs "appear to give DAF donors de facto control over investment and distribution decisions").

15. See Sherlock, *supra* note 8, at 3.

16. The National Philanthropic Trust provides a good working definition of donor advised fund: "A philanthropic giving vehicle administered by a charitable sponsor. A donor-advised fund allows donors to establish and fund the account by making irrevocable, tax-deductible contributions to the charitable sponsor. Donors then recommend grants from those funds to other charitable organizations." NPT 2016 REPORT, *supra* note 2, at 2. Compare, however, the description of DAFs offered by Giving USA: "Donor-advised funds are investment vehicles used by individual donors to make tax-deductible contributions earmarked for a specific charity." GIVING USA REPORT FOR 2015, *supra* note 3, at 232. The reference to earmarking is incorrect: donor funds are not earmarked, and donor advice formally need not be followed. The misstatement, though, points to the general sense that DAFs are "owned" by the donors, not the charitable sponsor, and that donor advice is followed. See, e.g., FIDELITY CHARITABLE, 2016 GIVING REPORT 4 (2016) [hereinafter FIDELITY 2016 REPORT] (using the possessive when stating that "[d]onors can support any IRS-qualified public charities with the money in *their* donor-advised funds").

17. The New York Community Trust is credited as creating the first donor advised fund in the 1930s. See Eleanor W. Sacks, *The Growing Importance of Community Foundations*, LILLY FAMILY SCHOOL OF PHILANTHROPY 8 (2014), [https://philanthropy.iupui.edu/files/file/the\\_growing\\_importance\\_of\\_community\\_foundations-final\\_reduce\\_file\\_size\\_2.pdf](https://philanthropy.iupui.edu/files/file/the_growing_importance_of_community_foundations-final_reduce_file_size_2.pdf) [<https://perma.cc/9K57-AUTD>].

18. See, e.g., Treas. Reg. § 1.170A-9(f)(10) (describing in general terms the characteristics of a community foundation).

easy to see how the idea of a DAF would arise and evolve. A DAF promised the donor professional fund management and the ability to work with the community foundation to remain involved with how the funds were spent.<sup>19</sup> Importantly, DAFs were and are but one tool used by community foundations to encourage gifts.<sup>20</sup> For donors willing to give with no retained involvement, a DAF would not be necessary. Today, community foundations are the most numerous of DAF sponsors (60%) yet hold a smaller proportion (25.3%) of DAF accounts.<sup>21</sup>

DAFs remained relatively obscure until the rise of the national sponsoring organization (NSO) in the 1990s.<sup>22</sup> NSOs are public charities with a national focus that administer DAFs as their main activity.<sup>23</sup> Under the NSO model, raising funds through a DAF is the reason the charity exists—i.e., the DAF as a fundraising device is the end, not a means. This is a significant departure from the historical norm, in which DAFs were housed within a charity that had a distinct charitable mission.

Many NSOs are affiliated with large investment firms, like Fidelity, Schwab, and Vanguard,<sup>24</sup> which account for three of the top eleven charities in the United State in terms of contributions received.<sup>25</sup> NSOs

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19. See Lila Corwin Berman, *Donor Advised Funds in Historical Perspective* 13–14, Boston College Law Forum on Philanthropy and the Public Good, 1 (Oct 2015), [https://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum\\_philanthropy/02\\_Berman.pdf](https://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum_philanthropy/02_Berman.pdf) [<https://perma.cc/5CGC-HZCH>].

20. “Community foundations commonly raise funds and make grants to support numerous charitable initiatives in their communities, and they hold endowments for local charitable projects in a number of funds, often including DAFs.” TREASURY REPORT, *supra* note 5, at 51.

21. In 2015, community foundations are second to national sponsoring organizations in terms of the percentage of DAF accounts held (25.3%), grants paid (28.5%), contributions collected (24.8%), and DAF account value (36.5%). NPT 2016 REPORT, *supra* note 2, at 8–9 (percentages are calculated from Figures 7, 8, 9, and 10).

22. See SHERLOCK & GRAVELLE, *supra* note 8 at 2.

23. See TREASURY REPORT *supra* note 5, at 51 n.73 (stating that “nearly all, if not all” of their activity “is administering DAFs”). NSOs are those “that have national reach and whose primary role is to serve as intermediaries between donors and a broad range of charities.” *Id.* at 21. The Treasury Department refers to national sponsors as “NDAFs.” This Article uses the term NSO, in order to retain a focus on the sponsoring organization.

24. The first commercially sponsored NSO, the Fidelity Charitable Gift Fund, became a 501(c)(3) charity with minimal IRS review in 1991, and today is the largest charity in terms of charitable gifts. See Phillips & O’Leary, *supra* note 2.

25. *Id.* In 2015, the Schwab Charitable Fund was fourth, the Vanguard Charitable Endowment Program was eleventh. See Drew Lindsay, Peter Olsen-Phillips & Eden Stiffman, *Fidelity Overtakes United Way as New Charity Champion*, CHRON. OF PHILANTHROPY (Oct. 27, 2016), <https://www.philanthropy.com/article/Fidelity-Overtakes-United-Way/238186> [<https://perma.cc/3YPB-22L5>].



with commercial affiliations<sup>26</sup> are poised to succeed. The for-profit firm provides a pre-established donor base in the form of its existing customers and also contributes a powerful brand that both reassures existing customers and attracts new ones. The commercial firm also has an incentive to assist the related NSO because the affiliated commercial enterprise typically manages the charitable gift funds (for a fee), and often bases the compensation of employees of the commercial firm on total funds under management, including funds owned by the NSO.<sup>27</sup> Thus, the commercial enterprise and its employees stand to benefit from the NSO's success. Altogether, NSOs amount to about one-half of the DAF industry even though they are the fewest in number (4.7%).<sup>28</sup>

In addition to community foundations and NSOs, DAFs also are used by charities that have a single issue or purpose,<sup>29</sup> including universities and religious organizations. The "single-issue" sponsor is the most amorphous type of sponsoring organization; it includes a wide range of 501(c)(3) organizations, which, like community foundations, use DAFs as a supplemental fundraising device.<sup>30</sup> A distinguishing feature of single-issue sponsoring organizations is that some are "primarily involved in the direct provision of charitable services."<sup>31</sup> This means that in contrast to NSOs, which mainly provide DAFs, and community foundation sponsors, which are primarily grant-making organizations, single issue sponsors generally are active charities. Single-issue

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26. Some NSOs have a national reach but are not affiliated with financial institutions, for example, the National Philanthropic Trust. TREASURY REPORT, *supra* note 5, at 52.

27. See Alan M. Cantor, Donor-Advised Funds and the Shifting Charitable Landscape: Why Congress Must Respond 134 (unpublished manuscript), [http://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum\\_philanthropy/08\\_Cantor.pdf](http://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum_philanthropy/08_Cantor.pdf) [<https://perma.cc/UD2P-A3SE>].

28. NSOs organizations sponsor roughly 57% of all DAFs, make 49% of all grants, collect 57% of all contributions, and hold nearly 49% of DAF account asset value. NPT 2016 REPORT, *supra* note 2, at 8–9 (percentages calculated from Figures 7, 8, 9, and 10).

29. "Some common Single-Issue Charities include universities, Jewish federations, other faith-based charities and issue-specific charities, such as those in the environmental, social justice or international relief arenas." NPT 2015 REPORT, *supra* note 2, at 2. A distinguishing feature of single-issue sponsoring organizations is that some are "primarily involved in the direct provision of charitable services." TREASURY REPORT, *supra* note 5, at 49.

30. According to the National Philanthropic Trust, a single-issue sponsoring organization is: "[a] tax-exempt organization that works in a specific topic area. Some common Single-Issue Charities include universities, Jewish federations, other faith-based charities, and issue-specific charities, such as those in the environmental, social justice or international relief arenas." NPT 2016 REPORT, *supra* note 2, at 2. The Treasury Department does not define the category but lists the issue types in its cataloging of sponsoring organizations. Issues included are education, health, religious, and other. TREASURY REPORT, *supra* note 5, at 47–48. The Treasury Department relied on the National Taxonomy of Exempt Entities classifications.

31. TREASURY REPORT, *supra* note 5, at 47–48.

sponsoring organizations constitute approximately 36% of sponsoring organizations,<sup>32</sup> with colleges and universities as the dominant type.<sup>33</sup>

### C. *Legal Issues, Legislation, and the Policy Debate*

The advent of the NSO gave rise to a number of legal issues. Although DAFs had been around for a long time, an organization with a genesis in the investment world that did nothing but sponsor DAFs was a new idea for a tax-exempt charitable organization. As a result, the NSO and the DAF became subject to considerable scrutiny.

An initial question was whether NSOs could qualify as 501(c)(3) organizations. Because NSOs administer financial accounts as their main activity, the charitable purpose was not initially clear.<sup>34</sup> Relatedly, commercially affiliated NSOs raised (and continue to raise) concerns about benefit to private parties. Under the private benefit doctrine, a 501(c)(3) organization may not be organized for the benefit of a private interest.<sup>35</sup> Because funds raised by the NSO typically are managed by the commercial entity that shares the NSO's name, there is a question whether the public purpose of raising funds for charity or the private benefit that flows to the commercial firm is dominant.<sup>36</sup> If the private benefit is the main reason for the NSO's existence, then the NSO should fail as a 501(c)(3) organization.

The extent of a donor's control over their DAF also caused concern. As a general rule, in order to claim a charitable deduction, donors may not retain dominion and control over donated funds but must make a completed gift.<sup>37</sup> Some of the new DAFs allowed a donor to continue as a matter of right to direct the investment or distribution of donated

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32. Single-issue sponsors sponsor roughly 17.5% of all DAFs, make 23% of all grants, collect 17.8% of all contributions, and hold 14.1% of DAF account asset value. Percentages compiled from information in NPT 2016 REPORT, *supra* note 2, at 8–9 (percentages calculated from Figures 7, 8, 9, and 10).

33. TREASURY REPORT, *supra* note 5, at 52.

34. As discussed in more detail in Part III, a longstanding basis for 501(c)(3) status is to raise funds for other charitable organizations, a standard NSOs easily satisfy.

35. Treas. Reg. § 1.501(c)(3)–1(d)(1)(ii) (as amended in 2014) (providing that a 501(c)(3) organization must serve “a public rather than a private interest”).

36. See RON SHOEMAKER, ET AL., INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1999, O. DONOR CONTROL (1999); RONALD J. SHOEMAKER & AMY HENCHEY, INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1996 M. DONOR DIRECTED FUNDS (1996).

37. See SHOEMAKER, *supra* note 36; SHOEMAKER & HENCHEY, *supra* note 36;

funds, calling into question whether a completed gift was made.<sup>38</sup> Further, concerns were raised that DAFs, though similar to private foundations, were not subject to private foundation rules, such as a mandatory payout requirement.

A comprehensive discussion of the resolution of these issues (some of which remain unsettled) is outside the scope of this Article. In short, during the 1990s, some issues were resolved in litigation,<sup>39</sup> and some through the exemption application process.<sup>40</sup> In the end, the IRS lost in court on exempt purpose, private benefit, and control issues,<sup>41</sup> and eventually yielded to the national sponsoring organization by granting public charity status to a major NSO—the Vanguard Charitable Endowment—after extensive review and negotiation.<sup>42</sup>

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38. Thus, the IRS developed a distinction between a donor “directed” fund and a donor “advised” fund, with directed funds disfavored because of the control donors retained. *Id.* The Treasury Department and the IRS addressed a similar issue in the 1970s in the context of trust funds set up at community foundations. Concerned that donor control over these funds could undermine the public charity status of the community foundation, the Treasury Department provided in regulations that if a donor places a material restriction on the use of donated funds, the fund would be treated as a private foundation and thus subject to tougher rules. Treas. Reg. § 1.170A-9(f)(10). These material restriction rules did not apply to NSOs, however, because NSOs generally are corporations. At the time, community foundations objected strongly that the NSO was little more than a way around the material restriction rules of the regulations, putting community foundations at a competitive disadvantage. *See, e.g.*, Jack Shakely, Letter to the Editor, *Commercial Gift Funds Flout Spirit of the Law*, CHRON. OF PHILANTHROPY, Feb. 6, 1997, at 38 (stating that the Fidelity Charitable Gift Fund does not “conduct donor education,” “has no program officers whatsoever,” does not perform an “independent investigation of grantees, assessment of community needs, [or] promulg[ate] grant guidelines”). Mr. Shakely has since recanted. Jack Shakely, *Who’s Afraid of DAFs?*, STAN. SOC. INNOVATION REV., Summer 2015, at 59.

39. *See, e.g.*, *Fund for Anonymous Gifts v. United States*, 194 F.3d 173 (D.C. Cir. 1999); *National Foundation, Inc. v. United States*, 13 Cl. Ct. 486 (1987).

40. The IRS scrutinized exemption applications and signaled in non-precedential guidance that it would be guided by the material restriction rules in assessing the exempt status of non-community foundation DAFs. Thus, new DAFs were encouraged to fall on the right side of the donor advice versus donor direction line. A related issue was whether donor directed funds counted as “publicly supported” for purposes of the public support test. In addition, the IRS also cited voluntary compliance with a 5% payout as a positive factor for exempt status. RON SHOEMAKER & BILL BROCKNER, INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2001, G. CONTROL AND POWER: ISSUES INVOLVING SUPPORTING ORGANIZATIONS, DONOR ADVISED FUNDS, AND DISQUALIFIED PERSON FINANCIAL INSTITUTIONS 119–21 (2001).

41. The control issues were resolved on the ground that the corporate sponsoring organization, as a separate and distinct entity, formally had dominion and control over donated funds. So long as the sponsoring organization has the clear legal right not to follow donor advice, donor advisory privileges are not a bar to a charitable deduction.

42. Paul Streckfus, *Vanguard’s Successful March To (c)(3) Exemption, Public Charity Status: A Charitable Gift Fund Case Study*, 3 EO TAX J. 33–100 (1998).

Nevertheless, the cumulative effect of years of wrestling with DAF-related issues generated a Treasury Department budget proposal in 2000 for DAF legislation.<sup>43</sup> The proposal sought uniformity across DAFs and would have required all DAF sponsors to distribute or pay out 5% of aggregate fund values each year for exempt purposes.<sup>44</sup> The proposal also would have restricted the class of eligible DAF grantees to public charities.<sup>45</sup>

The Treasury proposal was not enacted or re-proposed,<sup>46</sup> but concerns about DAFs remained. In 2005, IRS Commissioner Mark Everson raised awareness of DAF-related abuses by testifying before the Senate Finance Committee.<sup>47</sup> The following year, Congress enacted DAF legislation as part of the Pension Protection Act (“PPA”) amid a broader package of exempt organization reforms.<sup>48</sup>

Following the lead of the Treasury Department’s goal of uniform ground rules, the PPA DAF legislation applied to any DAF (as defined), regardless of the type of DAF sponsor.<sup>49</sup> The rules are animated by

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43. See DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2001 REVENUE PROPOSALS 105 (2000).

44. A 5% pay out rule would have put sponsoring organizations under a similar regime to that of private foundations, which are required to distribute 5% of non-charitable use assets each year for an exempt purpose. See I.R.C. § 4942 (2012). Under the proposal, for an organization that sponsored DAFs as its primary activity (meaning over 50% of assets held in DAFs), public charity status was available only if: there was no material restriction on any one DAF, DAF distributions could be made only to public charities, and in the aggregate 5% of total DAF assets were paid out each year. Failure to satisfy any of the three conditions resulted in private foundation treatment for the sponsoring organization and, therefore, the DAFs under its control. In addition, the proposal applied to the DAFs of organizations that did not offer DAFs as a primary activity (giving as an example, a school that operates a DAF). If such a DAF did not satisfy the three conditions, then it became subject to the private foundation rules, though the public charity status of the sponsor was not affected. DEP’T OF THE TREASURY, *supra* note 43, at 106.

45. *Id.* at 107.

46. The Treasury proposal coincided with the last year of the Clinton Administration and was not renewed by the incoming Bush Administration.

47. See Letter from Mark W. Everson, Comm’r of Internal Revenue, to The Hon. Charles E. Grassley, Chairman, Senate Comm. on Fin. (Mar. 30, 2005) (describing abuses at donor advised funds as a top compliance problem: “We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer’s personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible . . . . Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donors . . . to reimburse them for their expenses, or to fund their children’s educations.”).

48. For a description of all the rules imposed on DAFs, see STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS 624–44 (2007). The author was involved in the drafting of the donor advised fund legislation.

49. There is one exception. DAFs held by a private foundation are not subject to the rules. I.R.C. § 4966(d)(1)(B) (2012).

concerns about donor control and the abuse that can result. The main provision required that distributions by DAFs be to another public charity; distributions to individuals and private foundations were restricted.<sup>50</sup> The PPA also required the Treasury Department to report to Congress on a variety of issues relating to DAFs, including whether DAFs should be subject to a payout and whether a charitable deduction was appropriate for DAF gifts given the time lag between date of gift and distribution of funds.<sup>51</sup>

Subsequently, DAFs have remained in the spotlight. Perhaps most significantly, in 2014, the then-Chairman of the Ways and Means Committee, Representative Dave Camp, proposed a five-year payout for all donor advised fund contributions as part of tax reform.<sup>52</sup> DAF sponsors oppose the Camp proposal or any mandated payout, and generally praise the growth of DAFs as a sign of a vibrant charitable sector.<sup>53</sup> Critics of DAFs contend that DAFs face an inherent conflict of interest, hoard money, and should be subject to greater regulation.<sup>54</sup>

In short, since the rise of the NSO, DAFs have seen incredible growth and popularity as a charitable giving vehicle, amid many uncertainties about their role in private philanthropy and concerns about abuse. Clearly, DAFs would not be successful and growing if donors did not

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50. *Id.* § 4966. For a more detailed discussion of the PPA provisions see *supra* notes 63–69 and accompanying text.

51. The subsequent Treasury Department report, released in 2011, takes careful note of the different types of sponsoring organizations but does not make distinctions among sponsoring organizations in its recommendations to Congress. In conclusions largely favorable to the status quo, the report concludes that the favorable deduction rules for DAFs are appropriate because DAFs are not controlled by the donor (unlike a private foundation). In addition, the Treasury Department reasoned that although there may be a delay between the timing of the deduction and the delivery of charitable benefits, this delay also exists at other public charities, which nonetheless benefit from the favorable rules. The report also concluded that a payout on DAFs would be premature based on the limited data available. The report did leave open the door to future analysis of pay out trends and to work with Congress on whether additional regulation or legislation would be necessary. See TREASURY REPORT, *supra* note 5.

52. See Tax Reform Act of 2014, H.R. 1, 113th Cong., 2d Sess. (2014) (introduced by Rep. Dave Camp).

53. See, e.g., Joanne Florino, An Argument Against Congressional Response (unpublished manuscript), <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1021&context=philanthropy-forum> (last visited Mar. 20, 2017) (arguing that DAFs “are democratizing philanthropy and fostering more strategic and thoughtful giving” and that a pay out is not necessary); Victoria Bjorklund, *The Rise of Donor Advised Funds: Why Congress Should Not Respond*, 1 B.C. L. SCH. F. ON PHILANTHROPY & THE PUB. GOOD 69, <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1018&context=philanthropy-forum> (last visited Mar. 20, 2017).

54. See Lewis B. Cullman & Ray Madoff, *The Undermining of American Charity*, N.Y. REV. OF BOOKS (July 14, 2016), <http://www.nybooks.com/articles/2016/07/14/the-undermining-of-american-charity/> [https://perma.cc/9Q23-VCD7]; Cantor, *supra* note 27, at 134.

like the product. What is less clear, however, is the role the DAF plays or should play in the philanthropic ecosystem.

## II. UNTANGLING THE OVERLAPPING VIEWS OF DAFS

Whether to increase the regulation of DAFs is one of the principal policy issues facing the 501(c)(3) sector. To decide, it is necessary to consider what DAF contributions and DAFs represent. Are DAFs attracting money that would have been contributed anyway, but to a private foundation or to another public charity? Or are DAFs attracting new charitable contributions that otherwise would have been privately consumed? Each alternative destination for DAF contributions suggests a different regulatory approach. Relatedly, DAFs represent different things to different observers—some view DAFs as private foundation equivalents, others as something else.

This Part of the Article outlines three different, though not mutually exclusive, views of DAFs: as quasi-private foundations, as public charity substitutes, and as catalysts for new charitable giving. Each view provides insights about the role of DAFs in the philanthropic system and suggests ways in which DAFs should be regulated.

### A. *DAFs as Private Foundation Substitutes*

Perhaps the most common way to conceptualize donor advised funds is by analogy to the private foundation.<sup>55</sup> The comparison is made because DAFs and private foundations are both grant-making vehicles, subject to the direction or advice of the donor. In the case of a private foundation, a donor establishes and controls a separate entity, contributes funds, and then over time distributes the funds for the exempt purposes of the foundation. In the case of a DAF, a donor makes arrangements with a (typically pre-existing) private charity, the sponsoring organization, to open and administer a separate and distinct account often in the donor's name. The donor funds the account and then gives advice over time about account distributions, consistent with the donor's charitable preferences. In this way, private foundations and DAFs are quite similar.

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55. See, e.g., TREASURY REPORT, *supra* note 5, at 29 (stating that “[t]he closest analogue among private foundations to . . . DAFs are grant-making non-operating foundations”). The DAF is often coined as the “poor man’s private foundation.” Victoria B. Bjorklund, *Charitable Giving to a Private Foundation and the Alternatives*, SC74 ALI-ABA 69, 73 (1998). Private foundations can be “non-operating” or “operating.” The private foundation referred to in this Article generally is non-operating, meaning a grant-making organization.

A key difference between them is the legal control over funds exercised by donors. With the private foundation, donors and related parties may and do exercise control of donated funds through control of the foundation. With DAFs, donors typically do not control the sponsoring organization and, therefore, may provide only advice to the sponsoring organization about the distribution of fund assets.<sup>56</sup>

Nevertheless, although legal control over funds is vested with the sponsoring organization, for the DAF to be attractive to donors, there is a strong expectation that sponsoring organizations will follow donor advice as a matter of course.<sup>57</sup> If donor advice were not heeded, donors would quickly grow frustrated and end the relationship. Accordingly, donor advice is often thought of as a legal fiction.<sup>58</sup> Donors remain in effective control of the assets and can make grants in a similar manner as with a private foundation (though grants to individuals are generally not permitted).

As compared to a private foundation, though, the DAF is a tax-advantaged and less costly alternative. For federal income tax purposes, the amount allowed the donor as a deduction for many types of noncash contributions to a DAF sponsoring organization is larger than for contributions to private foundations.<sup>59</sup> Charitable contributions to DAF

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56. See generally *id.* at 78. When NSOs first emerged, an early question was whether donors provided “advice” (no legal control) or gave “direction” (legal control). See, e.g., SHOEMAKER & HENCHEY, *supra* note 36. If a donor retains control, then the contribution is not viewed as a completed gift, and no charitable deduction is allowed.

57. See TREASURY REPORT, *supra* note 5, at 69 (noting that “[n]o respondent reported ongoing disagreements with donors over the appropriateness of potential grants, and all respondents said that, in general, donor advice was followed”).

58. See SHERLOCK & GRAVELLE, *supra* note 8, at 3 (noting that “[e]vidence suggests . . . that donors to DAFs have effective control over grants, and to some extent investments, because sponsoring organizations typically follow the donor’s advice.”); TREASURY REPORT, *supra* note 5, at 69 (noting that one respondent thought that DAFs “appear to give DAF donors de facto control over investment and distribution decisions”). As an illustration of how DAFs are viewed in the field, Giving USA defines a donor-advised fund as:

An account by which donors may provide charitable gifts. This type of account is facilitated by community foundations or financial services companies. Donors typically contribute large amounts in the form of tax-deductible assets to these accounts in order to grow the assets, and donors usually *choose* to have significant *control* over the funds and *direct* which nonprofits will be recipients of the gifts.

GIVING USA REPORT FOR 2014, *supra* note 3, at 263 (emphasis added). The definition is a good example of the fact that legal formalities aside, in practice donors expect to control fund distributions.

59. In general, for contributions of appreciated property, the donor may deduct the fair market value of the property if given to a public charity, but may only deduct the cost basis if to a private foundation. See I.R.C. §§ 170(a), (e) (2012). Exceptions apply. See *infra* Part III for additional discussion.

sponsoring organizations also are subject to a higher cap.<sup>60</sup> Further, private foundations are subject to a tax on investment income, a payout requirement, a comprehensive self-dealing regime, and limitations on spending<sup>61</sup>—none of which apply to sponsoring organizations (or DAFs). In addition, donors do not have to set up or administer DAFs and so are free of compliance burdens.<sup>62</sup>

When donors choose a DAF instead of a private foundation, one regulatory model thus emerges. Viewed as a private foundation substitute, the question is simply whether the DAF is a loophole, i.e., a vehicle donors can use to avoid the private foundation regime. If so, then the issue is whether any or all of the private foundation rules, including the less favorable deduction rules and a payout, should apply to DAFs.

To date, the view of DAFs as quasi-private foundations has guided the legislative process. By enacting the PPA legislation in 2006, Congress determined that the public charity nature of DAF sponsoring organizations provided insufficient protection against abuse<sup>63</sup> and applied some of the private foundation rules (or close analogs) to DAFs.<sup>64</sup> Thus, Congress penalized certain transactions even if at arm's length,<sup>65</sup> restricted the types of permissible distributions from DAFs,<sup>66</sup> and directly applied the private foundation limits on the permissible holdings in any one business.<sup>67</sup> Congress did not, however, require a payout,<sup>68</sup> impose the harsher charitable deduction rules, or subject DAFs to a tax on investment income.<sup>69</sup>

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60. The cap is based on the donor's adjusted gross income. I.R.C. § 170(b).

61. *See id.* §§ 4940–45.

62. Private foundations also file a different information return, the Form 990-PF, than public charities.

63. The path for abuse is straightforward. A donor takes a deduction for a DAF contribution, and then advises out a grant that directly or indirectly benefits the donor. Unless a sponsoring organization is very active in supervising grants, this type of abuse would be fairly easy. This is the reason DAFs generally may not make grants to individuals, but are limited to public charities.

64. Congress implicitly copied the private foundation approach. For additional discussion, see Roger Colinvaux, *Charity in the 21<sup>st</sup> Century: Trending Toward Decay*, 11 FL. TAX REV. 1, 60–63 (2011). Congress did not distinguish among sponsoring organizations but focused on the DAF qua DAF.

65. *See* I.R.C. § 4958(c)(2) (2012) (prohibiting most transactions between a DAF and a donor-advisor or related party (e.g., sales, loans, compensation) even if at arm's length).

66. *Id.* §§ 4966–67 (subjecting DAF grants to individuals and grants for a noncharitable purpose to an excise tax).

67. *Id.* § 4943(e).

68. A payout was enacted in the Senate but did not survive final passage. The Tax Relief Act of 2005, S. 2020, 109th Cong. § 331 (2005) (as passed by the Senate November 18).

69. For a description of all the rules imposed on DAFs, see STAFF OF JOINT COMM., *supra* note 48, at 624–44.



The more DAFs are understood as private foundations, the more they resemble a loophole, and the stronger the logic for applying additional parts of the private foundation regime to DAFs.<sup>70</sup> Thus, one continuing thread of the policy debate is whether Congress should continue on the current path and apply more of the private foundation rules to DAFs and DAF sponsoring organizations.

*B. DAFs as Public Charity Substitutes*

Donor advised funds are also viewed as substitutes for other public charities. Under this view, DAFs offer the functionality of a private foundation but are funded with money that otherwise would have gone to another public charity.<sup>71</sup> For example, without a DAF, a donor would have given to a human services organization, the donor's alma mater, an art museum, or some other operating charity. When the donor instead contributes to a DAF, the DAF has altered the distribution of charitable funds. In a zero-sum game,<sup>72</sup> the success of DAFs comes at the expense of other public charities, deferring the date when operating charities can benefit from funds.

The substitution effect is plainest with respect to contributions to NSOs. There is no reason to give to an NSO but for the DAF. Thus, assuming a gift is a substitute, if not for the NSO, the gift would still be made, another public charity would benefit, and the donor would get the same tax benefit.

Substitution may occur at DAFs sponsored by other charities, but to a lesser extent. For example, if a donor creates a DAF at his alma mater, the same gift might have gone to the alma mater even without the DAF, so there is no substitution. Either way, the university receives the gift. The DAF in this context is merely an additional fundraising tool for the university.

Contributions to DAFs at community foundations present additional considerations. Community foundation DAFs may be substitutes for private foundations or other public charities, or, because community

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70. This was the initial approach of the Treasury Department, which in 2000 proposed regulating sponsoring organizations and DAFs (at the account level) as private foundations. *See* DEP'T OF THE TREASURY, *supra* note 43, at 105.

71. In general, the tax law divides section 501(c)(3) organizations into two broad categories: private foundation and public charity. The default characterization is a private foundation. Organizations avoid foundation status either based on their principle function (e.g., as a church, school, or hospital) or by reason of their public support. *See* I.R.C. § 509.

72. For illustrative purposes here, a zero-sum game is assumed. The assumption of a non-zero-sum game is discussed next.

foundations offer a unique form of community support, the community foundation DAFs might be more like a university, with no substitution.

In any event, the substitution effect plainly occurs at the NSO. In order to assess whether a substitution effect is beneficial, the nature of the DAF and the NSO must be closely considered.

If NSOs perform just like other public charities, then the federal tax issues raised by substitution are nothing new. The shift in charitable giving from one public charity to another would simply reflect a healthy competition. For example, if a new art museum is so successful that it attracts charitable gifts away from other art museums, the public still gets art (supported by the same donors), albeit in a different location and form.

A slightly different case arises if the new art museum attracts contributions that normally would have gone to the soup kitchen. Now, the success of art comes at the cost of serving the needy. This may be of concern (the competition now is perhaps less healthy), but non-interference with the substantive preferences of donors is an endemic policy of the charitable deduction, which largely avoids making value judgments about exempt purposes.<sup>73</sup>

NSOs, though, are not like other public charities. NSOs do not have an independent substantive charitable purpose or goal. NSOs are not formed to relieve poverty, eliminate malaria, improve education, foster community development, or achieve other concrete public ends.<sup>74</sup> Rather, NSOs essentially are fundraising organizations. The NSO principally collects funds, retains financial advice, and performs the administrative function of ensuring that the recipient suggested by the donor-advisor is on the IRS's list of eligible public charities.<sup>75</sup>

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73. The charitable deduction is generally value-neutral, based on the purposes of the organization. Value judgments are reflected in the purposes chosen—charitable, educational, scientific, religious, literary—but apart from that, the IRS mostly assesses means, not ends. Whether the charitable deduction should remain value neutral is a different debate outside the scope of this Article.

74. As Fidelity puts it: “The mission of the organization is to further the American tradition of philanthropy by providing programs that make charitable giving simple and effective.” FIDELITY CHARITABLE, *2015 Giving Report: A Deeper Look at Fidelity Charitable Donors and the Many Ways They Give 26* (2015) [hereinafter FIDELITY 2015 REPORT]. In its 2016 report, Fidelity added “accessible” to the mission. FIDELITY 2016 REPORT, *supra* note 16, at 2.

75. For example, as described by Fidelity: “Before making a grant, Fidelity Charitable conducts due diligence on recommendations to assure the funds will be used for charitable purposes.” FIDELITY 2016 REPORT, *supra* note 16, at 4. The due diligence referred to is checking the donor's suggested charity against the IRS list of qualified organizations. Noncharitable status would be the main basis for a sponsoring organization to reject a donor's advice. If a donor advises a grant to a bona fide public charity, and the sponsoring organization is unaware of any benefits flowing to the donor because of the contribution, then sponsoring organizations would be hard pressed (even though legally entitled) to reject donor advice. A sponsoring organization also might exercise due

Viewed as a fundraising organization and public charity substitute, the delay in distributions caused by DAFs at NSOs is problematic.<sup>76</sup> Without the NSO, the charitable funds would have gone immediately to an active charitable use.<sup>77</sup> With the NSO, the funds await the advice of a donor, which may be long in coming. The DAF here is little more than an intermediary, delaying the time at which the ultimate beneficiary receives control of the funds. A gift to the NSO represents charity, deferred.

Further, donors to NSOs are encouraged, implicitly or not, to defer charitable distributions, which makes the problem worse. For example, consider a hypothetical (but likely typical) contribution by a donor to the Fidelity Charitable Gift Fund.<sup>78</sup> The donor already has funds invested with Fidelity on a private, commercial basis. As the end of the year approaches, the donor receives charitable solicitations from a number of local charities but, as in prior years, has trouble deciding which ones to support and in what amount. Coincidentally, the donor then also receives a solicitation from Fidelity Charitable Gift Fund. The solicitation promises an immediate charitable deduction and tells the donor that he or she can advise at any time in the future about the eventual 501(c)(3) recipient.

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diligence and not make a grant if there were indications that the funds were to be used for noncharitable purposes, such as lobbying or political campaign activity.

76. There is a technical argument that DAF contributions do not result in a delay to a charity in receiving benefits. The argument would be that because a sponsoring organization is a bona-fide public charity, there is no delay because the funds have been contributed to charity. An analogy could also be drawn to funds contributed to any charity where the funds are not spent immediately, but accumulated by the charity for future use. In such (common) cases, there clearly is a delay or gap between the time of the deduction and the ultimate use of the funds for charitable beneficiaries. As discussed in Part III, NSOs, though public charities, are distinct from other organizations in that spending funds for the benefit of other charities is their main activity. Fidelity implicitly acknowledges this point in its marketing materials using the language quoted *supra*: “Before making a grant, Fidelity Charitable conducts due diligence on recommendations to assure the funds *will be used* for charitable purposes.” FIDELITY 2016 REPORT, *supra* note 16, at 4 (emphasis added). Note the implicit acknowledgement that DAF funds are held for future charitable use, i.e., the fact that the funds already have been contributed to charity does *not* denote a current charitable use, notwithstanding the argument that NSOs are independent public charities. See FIDELITY CHARITABLE, POLICY GUIDELINES: PROGRAM CIRCULAR (2016), <http://www.fidelitycharitable.org/docs/Gift-Fund-Policy-Guidelines.pdf> [<https://perma.cc/L2CW-SVDL>].

77. It might be rebutted that if the gift went to a university, for example, instead of an NSO, the university (or other charity) might put the funds into its endowment, or otherwise decide not to put the funds to “an active charitable use.” This objection misses the point, however. The key consideration is that the university (or other charity) has ownership of the funds. The university might accumulate funds excessively, but this is a different issue—at least the university has the funds. With an NSO, the funds are parked in a way station, not earmarked for any charity or cause.

78. The Fidelity Charitable Gift Fund is chosen by reference here because it is the largest sponsoring organization of DAFs in the United States. See Phillips & O’Leary, *supra* note 1.

Given the donor's indecision about which charities to support, the offer is well-timed, and the donor establishes a DAF with Fidelity. The donor has made a deductible charitable contribution, and because the donor has legally parted with the funds, may feel the "warm glow" often associated with charitable giving. The arrangement also suits Fidelity because the funds remain under management by the for-profit side of Fidelity, thereby continuing to earn management fees.<sup>79</sup> Thus, there is an inherent conflict of interest between the NSO's mission (to facilitate charitable distributions) and the mission of the for-profit enterprise (to keep funds under management).

After the initial deferral, the donor may even reconsider how to give in the future. Before the DAF, the donor might have made contributions to a variety of public charities in small amounts each year. But now that the donor's annual giving may accumulate in a DAF, the donor starts to think about giving differently—less as making current contributions and more as saving for the future. For example, the donor might decide to accumulate assets in order to build up a sufficient sum so as to advise distributions of just the income each year, or to involve the donor's children in grant-making. Such a shift in attitude toward giving likely is reinforced by the fact that many sponsoring organizations have relatively high contribution thresholds of several thousand dollars for initial gifts.<sup>80</sup> For the donor, this reinforces the idea that money set aside in a DAF is more of an investment than a spending transaction.

Relatedly, donors may become possessive of their DAF. The donor knows that the money formally is out of her legal control, but this is not transparent. The funds, prior to contribution, were held and managed by Fidelity in a mutual fund in her name. After the contribution, the funds are held and managed by Fidelity in a mutual fund in her name. The

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79. Arguably, the federal government is disadvantaged by the transaction. If the donation is \$10,000 and the donor is in the 35% tax bracket, then the government supports the transaction by foregoing \$3500 in revenue. But the payoff to the government does not occur until the donor advises that the money be distributed from the DAF. However, if the deduction were delayed until distribution, it does not necessarily follow that the government is better off. If the asset is noncash, the donor might be worse off using a DAF. See John R. Brooks, *The Missing Tax Benefit of Donor-Advised Funds*, 150 TAX NOTES 1013 (2016) (arguing that because unrealized gains are not taxed, donors generally would be better off holding onto an appreciated asset, giving later, and getting a larger deduction). Professor Brooks' argument carries more weight with respect to highly liquid property than illiquid, which is often sold promptly upon donation. See discussion *infra* Part IV.

80. For example, the minimum amount to start a DAF at Fidelity or Schwab is \$5000. See *What it Costs*, FIDELITY CHARITABLE, <https://www.fidelitycharitable.org/giving-account/what-it-costs.shtml> [https://perma.cc/DNP8-YNFV]; *Schwab Charitable*, CHARLES SCHWAB, [http://www.schwab.com/public/schwab/investing/accounts\\_products/accounts/trust\\_estate/donor\\_advised\\_fund](http://www.schwab.com/public/schwab/investing/accounts_products/accounts/trust_estate/donor_advised_fund) [https://perma.cc/8L6U-B8VX].

funds may even be in a similar mutual fund as before the contribution.<sup>81</sup> The donor knows Fidelity is unlikely to distribute money from her DAF without her advice. She receives quarterly statements showing investment gains in her account.

Taken altogether, from the donor's perspective, the money in the DAF still feels like it is "hers," subject to her will. As additional reinforcement, sponsoring organizations honor advisory privileges across generations,<sup>82</sup> meaning that the ability to advise becomes a kind of asset that the donor can pass on to her heirs outside the property system, but only if the donor does not spend the money. The DAF has converted a donor from a charitable spender on current needs to a charitable saver for future needs.

In sum, viewed as public charity substitutes, contributions to NSOs represent a delay to charity, pure and simple. Instead of receiving a contribution in year one, the art museum receives a contribution in year two, or year three, four, five, or never. True, a contribution received later might be larger due to investment gains,<sup>83</sup> but if the contribution was made in year one, the donee then could also have reaped those gains, and more importantly, would have had discretion about how best to use the funds, discretion that is deferred by the DAF intermediary.<sup>84</sup>

The delay in charitable distributions caused by DAFs at NSOs could be addressed broadly in one of two ways. One is to mandate an aggressive payout, far in excess of the private foundation payout, to minimize the extent of the delay. Another would be to delay the charitable deduction for contributions to sponsoring organizations to match the distribution from the donor advised fund. Both approaches are discussed in more detail in Part III.

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81. "At Fidelity Charitable, donors can recommend an investment strategy that aligns with their goals and giving time horizons through Fidelity Charitable's investment pools or investment advisor-managed accounts." FIDELITY 2015 REPORT, *supra* note 74, at 3.

82. As reported by the Treasury Department: "A sponsoring organization . . . may allow a donor to appoint a successor advisor for the DAF, e.g., a spouse, child, or other descendant, who would continue to make recommendations regarding distributions from the account." TREASURY REPORT, *supra* note 5, at 22.

83. The contribution also could be smaller due to investment losses.

84. It is often noted that DAFs increase charitable giving through investment growth. Fidelity incorporates asset growth as part of its giving philosophy, "Give, Grow, Grant," and says that "[i]nvestment growth has generated \$3.6 billion in additional charitable dollars." FIDELITY 2015 REPORT, *supra* note 74, at 12. Asset growth also is viewed not "as capital denied to charity [but] instead can be understood as a major philanthropic capital reserve fund . . ." HOWARD HUSOCK, GROWING GIVING: AMERICAN PHILANTHROPY AND THE POTENTIAL OF DONOR-ADVISED FUNDS 7 (2015).

### C. *DAFs as Vehicles for New Giving*

Another way to view DAFs is as vehicles that spur new charitable giving. Here, DAFs are not diverting contributions from one part of the charitable sector to another. Rather, DAFs are the reason donors give.

For example, an investor with Schwab may have never made charitable contributions before. But after hearing his friends and colleagues talk about their DAFs, he decides to open an account—either from peer pressure or just because the DAF appeals to his giving matrix in a way that other charities never did.

DAFs could also encourage supplemental giving. For instance, a donor who regularly gives 2% of her income each year to active public charities decides upon creating a DAF to add DAF contributions to her giving profile, increasing overall giving to 2.5% of her income each year.

In addition, donor advised funds likely attract new charitable gifts when donors have a financial windfall, e.g., through inheritance or a bonus.<sup>85</sup> In such cases, a DAF offers a convenient way to make a large charitable gift before the donor digests the windfall into her personal portfolio (becoming possessive of it) and without having to select beneficiaries right away, a burden that might otherwise have thwarted the gift.

Also, as discussed in Part IV, DAFs increasingly are used for contributions of complex assets, which other public charities might not accept and are not tax-preferred if given to a private foundation. Gifts of complex assets could represent new giving, but only to the extent that donors do not reduce other giving to compensate, which many donors likely would.<sup>86</sup>

As a possible source of new contributions, one response is to adopt a celebratory tone and advocate a hands-off regulatory approach. After all, if regulation undermines the fundamental appeal of DAFs for donors, the risk is that DAFs as a catalyst for charitable giving would be eliminated, which would be counterproductive. Further, why regulate at all? Just because the DAF is a bountiful vehicle should not mean that regulation must follow—like a moth to a flame.

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85. Fidelity reports that 27% and more than one-third of high net worth donors use donor advised funds to absorb financial windfalls. FIDELITY 2015 REPORT, *supra* note 74, at 22.

86. In other words, gifts of complex assets through DAFs are substitutes for other gifts.

As a practical matter, however, it is highly unlikely that most DAF contributions to NSOs (\$12.77 billion in 2015)<sup>87</sup> are new giving. People give from a sense of generosity, a desire to help others, from deeply held beliefs, or from duty.<sup>88</sup> Certainly, in the margins, DAFs might generate new gifts for the reasons suggested, but the core desire to give is based on human nature, not the abstract features of a financial product. It is telling that individual giving as a percentage of disposable personal income has been largely fixed at 2% over a forty-year period.<sup>89</sup>

Regardless, even making the unrealistic assumption that all DAF contributions are gifts that donors would not otherwise make, the federal government still has an interest in ensuring that DAFs work for the charitable sector as a whole, and not just in preventing their abuse. The next two parts of this Article focus on the question of the appropriate regulatory response to DAFs, taking into account the multiple ways DAFs are used and the different types of DAF sponsors.

### III. A PAYOUT FOR DAFS AT NATIONAL SPONSORING ORGANIZATIONS

The use of DAFs cannot be ignored. When five out of eleven of the most successful charitable fundraisers are DAF sponsors,<sup>90</sup> and a main result is that charitable distributions are deferred, regulators must pay attention. The challenge, as the first two parts of this Article have

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87. NPT 2016 REPORT, *supra* note 2, at 9. This is an increase of 3.11 billion dollars from 2014. NPT 2015 REPORT, *supra* note 5, at 9.

88. See Lise Vesterlund, *Why Do People Give?*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK, 568–90 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006); René Bekkers & Pamala Wiepking, *Generosity and Philanthropy: A Literature Review* 20 (Oct. 28, 2007) (unpublished manuscript), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1015507](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1015507) [https://perma.cc/8W7C-H8KP] (surveying the literature on giving and listing eight factors explaining why people give as “(1) awareness of need; (2) solicitation; (3) costs and benefits; (4) altruism; (5) reputation; (6) psychological benefits; (7) values; (8) efficacy”).

89. According to Giving USA, in both 1975 and 2015, individual giving as a percentage of disposable personal income (DPI) was 2%. GIVING USA REPORT FOR 2015, *supra* note 3, at 327. In the intervening years, the percentage fluctuated slightly above and below 2%, going as low as 1.7% (1995) and as high as 2.4% (2000). *Id.* This suggests that individuals in the aggregate give about 2% of DPI to charity, regardless of the giving vehicle. This is one indicator that DAFs primarily are substitutes and without them about the same amount of giving would occur. A different “2%” number—giving as a percentage of gross domestic product—is sometimes also used to assess whether giving levels change or remain constant over time. Giving USA also calculates this percentage (1.7% in 1975 and 2.1% in 2015). *Id.* at 326. But this percentage is less useful than individual giving as a percentage of DPI because it uses “total giving” in the numerator. Total giving is not the same as new giving by individuals, but includes giving already counted as well as corporate giving.

90. See Phillips & O’Leary, *supra* note 2.

shown, is to put the DAF within an analytical framework so that any regulatory response makes sense.

When considering regulation, it is important to recognize that a DAF is an activity of an organization, not an entity. So even though it is common to focus on the DAF, rules relating to DAFs apply to the sponsoring organization that administers the DAF. The sponsor, not the DAF, is granted 501(c)(3) status based on its purposes and operations.

Yet not all sponsoring organizations are the same. When the DAF is part of a charity that has other goals, as with a community foundation or single-issue charity, the DAF is not an end in itself but an activity used in furtherance of those goals. As a general matter, donors to these DAF sponsors are attracted to the underlying mission of the sponsor, contributions are earmarked for a particular cause or charity, and the advice offered by donors should fit within the mission of the underlying charity. This was the historic model for the DAF.

The NSO, though, is a different type of sponsoring organization. A DAF at an NSO does not further any concrete charitable purpose nor does it benefit any active charity (until distribution). When NSOs create a substitution effect, the positive benefit of DAFs is questionable.

A first step in devising a regulatory approach to DAFs is to recognize that the NSO is a distinct type of charity, and so warrants a distinct response. The legal and policy challenge is to start from first principles. How should NSOs be regulated? What is the appropriate role of the NSO in the philanthropic system? What are NSOs good at? What are NSOs good for? This part of the Article characterizes the national sponsoring organization as a fundraising organization that meets its charitable objective through spending and argues that a payout for DAFs sponsored by NSOs is appropriate.<sup>91</sup>

#### A. *Exempt Purpose of NSOs*

The initial question is why NSOs qualify as public charities. The NSO primarily collects, invests, and distributes charitable contributions. As explained by the Treasury Department:

The main characteristic of [NSOs] is that the sponsorship of the DAFs and other similar accounts or funds generally appears to constitute the principal activity performed by the sponsoring organization. The organizations largely focus on receiving contributions, converting non-cash donations into a more liquid

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91. The transition in this Part to focus on the national sponsoring organization does not absolve other DAF sponsors from concern.



form, facilitating grant-making, and managing the investment of DAF assets, rather than the direct provision of charitable services.<sup>92</sup>

As organizations “whose primary role is to serve as intermediaries between donors and a broad range of charities,”<sup>93</sup> NSOs do not perform a hands-on advisory role.<sup>94</sup> Although NSOs may provide donors with general information and resources about 501(c)(3) organizations, the NSO exists to manage donor accounts and distribute their donations not to consult with donors.

As an intermediary or conduit between donor and other 501(c)(3) organizations, NSOs in effect are no more than fundraising organizations. The exempt status of the fundraising organization is derived from a 1967 IRS Revenue Ruling in which the IRS held that an organization “formed for the purpose of providing financial assistance to several different types of [501(c)(3)] organizations” was itself a 501(c)(3) organization.<sup>95</sup> The organization in the ruling carried “on no operations other than to receive contributions and incidental investment income and to make distributions of income to such exempt organizations at periodic intervals.”<sup>96</sup> Under this line of legal authority, the plain basis for 501(c)(3) status for the NSO is that it “receive[s] contributions” and “make[s] distributions” to other organizations for charitable purposes.<sup>97</sup>

Notably a failure to make sufficient distributions would mean that the organization fails the operational test for exempt status. If, for example, an organization received one million dollars a year, but only paid out 100 dollars a year to charity, the question would arise whether the organization would be recognized as a 501(c)(3). The organization would remain “organized” for an exempt purpose—to receive contributions and pay out to charity. But if the payout is negligible, then

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92. TREASURY REPORT, *supra* note 5, at 49.

93. *Id.* at 21.

94. When a donor advises a distribution, the NSO checks that the proposed recipient is eligible (information that is publicly available) and then makes the distribution. Rejection of donor advice is rare. For example, as reported by the Treasury Department: “No [DAF sponsor] reported ongoing disagreements with donors over the appropriateness of potential grants, and all respondents said that, in general, donor advice was followed.” *Id.* at 69.

95. Rev. Rul. 67-149, 1967-1 C.B. 133. The ruling in turn is derived from a 1924 Supreme Court decision, *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

96. Rev. Rul. 67-149, 1967-1 C.B. 133.

97. *Id.* There are peripheral grounds for exemption—such as education of donors about philanthropy, but national sponsoring organizations are not educational organizations.

the organization would not be “operated” primarily for an exempt purpose.

In practice, the IRS has conditioned the exempt status of fundraising organizations on whether the organization pays out commensurate with its financial resources, also known as the “commensurate in scope test”.<sup>98</sup> Under this test, it is not enough for an organization to say it will pay money to charity (when that is the organization’s only purpose); it must also make sufficient distributions.<sup>99</sup> The commensurate in scope test has led to considerable confusion because it is not clear when it

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98. See INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1989, M. SPECIAL EMPHASIS PROGRAM—CHARITABLE FUND-RAISING (1989), <https://www.irs.gov/pub/irs-tege/eotopicm89.pdf> [<https://perma.cc/DZJ2-XUYE>] [hereinafter IRS FISCAL YEAR 1989]. The commensurate in scope test began as a tool to determine an organization’s primary purpose in cases where the activity of the organization is commercial in nature and not inherently charitable. The test is a variation on the destination of income doctrine articulated by the Supreme Court in 1924 in the case of *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). Under the destination of income test for exemption, what matters is not whether an organization’s activities are charitable, but the destination of the income from the activities. Congress responded to the destination of income test in 1950 by enacting a rule barring exempt status for feeder corporations (for profit organizations that turn over all the profits to charity), I.R.C. § 502 (2012), and by creating the unrelated business income tax, *id.* §§ 511–14. Destination of income as a basis for exempt status mostly remained intact, except in cases where the primary purpose of the organization is for-profit trade or business activity. For discussion of the commensurate in scope test, see Jack Siegel, *Commensurate in Scope: Myth, Mystery, or Ghost?—Part One*, 20 TAX’N OF EXEMPTS 26 (2008). See also John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 514 (2002) (discussing the commerciality doctrine and the commensurate in scope test); Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2487 (2005) (noting that the role of the commensurate in scope doctrine “appears to be to permit decision makers to approve of charitable status for commercial charities that have appealing missions and that spend most of their commercially raised funds on their charitable purposes”).

99. The IRS first articulated the commensurate in scope test in a 1964 Revenue Ruling. Rev. Rul. 64-182, 1964-1 C.B. 186. This Ruling concerned an organization that owned and operated a commercial office building. The principal source of income for the organization was rent from the building. *Id.* Rent is passive income exempt from the unrelated business income tax. If the activity was subject to UBIT, then the organization would have failed 501(c)(3) status as a feeder corporation. Because the activity was exempt from UBIT, but the activity was still commercial in nature, the question arose whether a non-feeder fundraising organization could qualify. The organization paid the rent it collected from commercial tenants to section 501(c)(3) organizations. As described by the IRS, “[t]he charitable purposes of the corporation are carried out by aiding other charitable organizations, selected in the discretion of its governing body, through contributions and grants to such organizations for charitable purposes.” *Id.* The organization would be entitled to exemption “where it is shown to be carrying on through such contributions and grants a charitable program commensurate in scope with its financial resources.” *Id.* Translation: the fundraising purpose of the organization is sufficient, but exemption is contingent on whether the organization spends enough.

applies,<sup>100</sup> nor is it clear what the test requires when it does apply. As the IRS has said on numerous occasions: “[t]he ‘commensurate test’ does not lend itself to rigid numerical distribution formulas—there is no fixed percentage of income that an organization must pay out for charitable purposes.”<sup>101</sup> Rather, “the particular facts and circumstances of the fundraising organization must be considered.”<sup>102</sup>

Regardless, the important point in the context of NSOs is that the commensurate in scope test has been consistently applied to assess the exempt status of fundraising organizations.<sup>103</sup> In other words, as fundraising organizations, NSOs are *already* subject to a payout requirement, albeit an uncertain one.<sup>104</sup>

In addition, when considering the NSO as a fundraising organization, it is important to recognize that its case for 501(c)(3) status is qualitatively weak. Notwithstanding that the fundraising rationale for exempt status is longstanding, the 501(c)(3) fundraising organization stands at the edge of legitimacy. Charity is accomplished in the doing.

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100. In 2007 and 2008, the specter of the commensurate in scope test was raised in connection with university endowments. See Jack Siegel, *Commensurate in Scope: Myth, Mystery, or Ghost?—Part Two*, 20 TAX’N OF EXEMPTS 8 (2009) (citing Letter from Senators Max Baucus and Charles Grassley to Secretary of the Treasury Henry Paulson (May 29, 2007) (suggesting the Treasury and IRS should “put more teeth” into the commensurate in scope test)).

101. IRS FISCAL YEAR 1989, *supra* note 98, at 13.

102. *Id.* at 13–14.

103. *Id.* at 13 (“Whether a fund-raising organization’s activity may be said to accomplish exempt purposes often centers on the issue of whether there has been a sufficient turnover of funds to charity. This issue is resolved through use of the ‘commensurate test’ . . . .”); INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1986, G. UPDATE ON FUNDRAISING 3 (1986) (noting that the commensurate in scope test “remains the basis by which such fundraisers are tested. If this test is met, exemption will not be foreclosed to an organization notwithstanding that its primary fundraising activity in carrying out its purposes is not inherently charitable or is an unrelated trade or business.”); INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1982, L. FUNDRAISING 48 (1982) (“The commensurate test has been used as the dominant rationale for fund raising event exemption cases in recent years”, but has been applied “with confusion and inconsistency.”).

104. The fact that NSOs must pay out funds as a component of their 501(c)(3) status is not widely understood but should be self-evident. If an NSO paid out no money to 501(c)(3) organizations (and had no plan to do so), the sponsoring organization should lose exempt status by failing the commensurate in scope test. As the IRS has said: “an organization that raises funds for charitable purposes but consistently uses virtually all its income for administrative and promotional expenses with little or no distribution to charity cannot reasonably argue that its distributions are commensurate with its financial resources and capabilities.” See IRS FISCAL YEAR 1989, *supra* note 98, at 14.

To grant “charitable” status<sup>105</sup> to a shell seems awkward and counterintuitive.

As a result, in order to achieve 501(c)(3) status as a fundraiser, the formalities are important. If an organization raises and distributes money for specific charities by contract the organization, though arguably serving an exempt purpose, does not qualify as a 501(c)(3). For example, in one IRS ruling, even though an organization’s “activities consist[ed] entirely of providing fundraising services to organizations[,]” exempt status failed because the services were a commercial fee-for-service activity and the organization did not retain control of the funds.<sup>106</sup> The distinction with an NSO is clear because NSOs do not have contractual relationships to collect money for specific charities. Even so, both the NSO and the organization in the ruling perform essentially the same function—fundraising for charity.<sup>107</sup> Section 501(c)(3) status turns on legal formalism.

Fundraising organizations face an additional hurdle in attaining exempt status, namely acute concerns about private inurement and private benefit. For an organization to qualify as a 501(c)(3), it must not inure to the benefit of organization insiders,<sup>108</sup> and must serve “a public rather than a private interest.”<sup>109</sup> In the fundraising context, it is not uncommon for the putative 501(c)(3) organization to have pre-existing relationships with for-profit companies that benefit from the fundraising activity.<sup>110</sup> Thus, the IRS has concluded that even if a charity benefits from the fundraising, the fundraising organization is not exempt because of the private benefit that flows to a related entity.<sup>111</sup>

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105. Contributions to any 501(c)(3) organization technically are “charitable” contributions. I.R.C. § 170(c) (2012).

106. *See* I.R.S. Priv. Ltr. Rul. 201438029 (May 14, 2014) (concluding that “[y]our fundraising services do not constitute the provision of grants to charities, rather they are services that are bought by the charities”).

107. At bottom, the fees collected by the sponsoring organization come from the same source as the organization in the ruling—out of donor contributions.

108. The Code requires that for an organization to qualify as a 501(c)(3), “no part of the net earnings [may] inure[] to the benefit of any private shareholder or individual . . .” I.R.C. § 501(c)(3).

109. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2014). The regulation further provides: “it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.”

110. *See* INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1990, K. FUNDRAISING UPDATE 12 (1999).

111. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201438029 (May 14, 2014) (concluding that in addition to not having an exempt purpose, the organization provided a substantial private benefit because the

To summarize the legal hurdles facing fundraising organizations:

If the ‘commensurate test’ is met, an organization may qualify for exempt status under IRC 501(c)(3) notwithstanding the fact that the fund-raising activity itself is not inherently charitable or is an unrelated trade or business. However, even if an organization makes a real and substantial contribution to charity commensurate with its financial resources, a substantial private purpose may still be found that will disqualify it from IRC 501(c)(3) exemption.<sup>112</sup>

The comparison to national sponsoring organizations is acute. Private benefit concerns have long dogged NSOs.<sup>113</sup> As described in Part I, the commercially sponsored NSO may formally be an independent organization, but nevertheless it has an existential relationship with a for-profit investment firm, which precedes the charity in every case. The for-profit arms of Fidelity, Vanguard, Schwab, and other commercial investment firms that sponsor DAFs all benefit from the fees earned by DAF accounts. Further, there is an inherent tension, if not a conflict of interest, between the mission of the NSO (to distribute funds) and the mission of the for-profit (to hold and invest funds).<sup>114</sup> And, as discussed in Part IV, as the solicitation and liquidation of complex assets becomes

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organization was founded by a for-profit company, four of its six directors are related through their work with the company, the organization licensed a product owned by the company, and had a management agreement with the company whereby the organization paid the company \$25,000 a month plus 2% of all of the donations).

112. See IRS FISCAL YEAR 1989, *supra* note 98, at 14–15.

113. Private benefit concerns were rife at the time sponsoring organizations were seeking exemption, though eventually turned out not to be a bar. See SHOEMAKER *supra* note 36; SHOEMAKER & HENCHEY *supra* note 36; Albert R. Rodriguez, *The Tax-Exempt Status of Commercially Sponsored Donor-Advised Funds*, 17 EXEMPT ORG. TAX REV. 95 (1997). The issue though continues to simmer. Relatedly, the Treasury released private benefit regulations, which could affect the calculation going forward. Treas. Reg. § 1.501(c)(3)-1(d)(1) (as amended in 2014). The IRS has applied the regulations to disqualify organizations “where a charity was essentially required to use the services of a particular commercial entity, even where the fees charged represented fair market value.” See Paul Streckfus, *Commercial DAFs and Private Benefit*, EO TAX JOURNAL 2015-164 (comments of Marcus Owens). Owens notes that one possible issue is:

[W]hether ‘commercial DAFs,’ *e.g.*, DAFs formed and managed by commercial investment businesses, are incompatible with notions of private benefit as set forth in the 2008 private benefit regulations (and the private benefit court decisions). Will we ever see, for example, Fidelity Charitable Gift Fund turning to Vanguard or Schwab for investment and sales management? Will Schwab or Vanguard sales representatives ever recommend Fidelity Charitable Gift funds to clients?

*But see* HUSOCK, *supra* note 84, at 6 (“Ultimately, the debate over DAFs is one not about fees that may flow to private financial firms but about whether the U.S. wants to encourage growth in charitable giving as a portion of the economy.”).

114. See *supra* Part I.

the primary activity of NSOs, the NSO increasingly resembles a commercial undertaking.

All that said, NSOs indubitably are recognized as 501(c)(3) public charities. Whatever private benefit exists in current arrangements would at this stage appear unlikely to jeopardize exempt status (if only because the arrangements are well established, the stakes are high, and the IRS is timid). It also is unlikely that the IRS would challenge exempt status based on the commensurate in scope test.<sup>115</sup> Nevertheless, even though the public charity status of NSOs has been established, the case for exempt status is weak. As a fundraising organization, the NSO qualifies on the basest of grounds—paying out to others—and amidst concerns about private benefit.

### *B. A Fund-Based Payout in Fulfillment of Exempt Purpose*

Several factors point to adoption of a rule that specifies the rate of distribution from DAFs at NSOs. These include the fact that fundraising organizations already are required to pay out funds, the relatively weak case for exempt status, and the fact that not all NSO contributions represent new giving, but come at a cost to active public charities.

As a fundraising organization, the 501(c)(3) mission of the NSO and the basis for its exempt status is to collect and distribute money. The principal issue is the appropriate rate of distribution. The IRS through regulations, or, if the IRS does not act, Congress through legislation, should apply the commensurate in scope test with a bright line. Under a bright line test, NSOs should be required to ensure that each DAF under their control pays out contributions (measured annually) within a range of five to ten years.<sup>116</sup> Whatever number is settled on (be it a five-year payout or ten), what matters is that the payout is set so that it is long enough that the appeal of DAFs for donors that would not otherwise give is not undermined, but is not so long that the delay in distributions that results when donors use DAFs as public charity substitutes is not excessive. In other words, the ideal spending period would be one that

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115. The IRS could argue that the commensurate test requires a sponsoring organization to have in place a policy that each DAF account spend commensurate with its resources.

116. In theory, the payout rate could be as high as 100%, on the view that, notwithstanding that formal legal control is vested in the sponsoring organization, NSOs are essentially conduits, and as substitutes for gifts to other public charities, the distribution should be delayed no longer than necessary. Although a 100% payout may sound extreme, a similar payout is used to permit conduit foundations to be eligible for the 50% limitation. I.R.C. § 170(b)(1)(A)(vii) (2012); *id.* § 170(b)(1)(F)(ii); Treas. Reg. § 1.170A-9(h) (as amended in 2011) (“[p]rivate nonoperating foundation distributing amount equal to all contributions received”).

does not deter too many new donors while limiting the net detriment to charity that occurs when DAFs are used as public charity substitutes. To the extent that DAF contributions are in lieu of private foundation contributions, there is no issue except that these donors may opt for a private foundation instead of a DAF in search of a lower payout (but more control).

One objection to a payout is that it is unnecessary. Many NSOs claim to already pay out at high levels and so argue that a payout is redundant. For example, the Schwab Charitable Fund reports that on average their DAFs distribute 20% a year, well in excess of the private foundation 5% payout requirement.<sup>117</sup> Fidelity says that since it started operations in 1991, 61% of contributions have been distributed and that a majority of contributions are distributed within a decade.<sup>118</sup> For NSOs as a whole, the National Philanthropic Trust reports an aggregate payout rate of 21.4%.<sup>119</sup>

These payout levels, though generally robust, are largely beside the point. The payouts reported by sponsoring organizations are at the aggregate level, not the fund level, thus the numbers do not really reveal very much. Some individual funds pay out at very high levels—as high as 100%.<sup>120</sup> High payouts by some funds mean that many funds held by the same sponsoring organization pay well below the mean.<sup>121</sup> Assume for example that a sponsoring organization holds 1,000 DAFs, and each DAF has an asset value at the beginning of the year of \$10,000. If 200 DAFs paid out \$10,000 (a 100% rate) and the remaining 800 DAFs paid

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117. *Annual Giving Report 2015*, SCHWAB CHARITABLE (2015), <http://www.schwabcharitable.org/public/file/P08142068/GivingReport2015.pdf> [https://perma.cc/3DLG-LUGT]; see also NPT 2015 REPORT, *supra* note 2. The National Philanthropic Trust also reports a 20% average payout. *Id.* at 6.

118. See FIDELITY 2016 REPORT, *supra* note 16, at 14.

119. See NPT 2015 REPORT, *supra* note 2, at 10.

120. Paul Arnsberger, *Donor-Advised Funds: An Overview Using IRS Data*, 1 B.C. L. SCH. F. ON PHILANTHROPY & THE PUB. GOOD 61, 67 (2015), <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1017&context=philanthropy-forum> [https://perma.cc/UGZ7-4ZNQ] (Figure D).

121. The IRS reports that the median payout for all donor advised funds (not just those held by NSOs) is 10%. Paul Arnsberger, *Nonprofit Charitable Organizations and Donor-Advised Funds, 2012*, in INTERNAL REVENUE SERV., STATISTICS OF INCOME BULLETIN, WINTER 2016 4 (2016). This contrasts with the mean data reported by the National Philanthropic Trust for each of the sponsoring organization categories: NSOs (21.4%); community foundations (18.2%); and single-issue charities (33.2%). NPT 2015 REPORT, *supra* note 2, at 10. The IRS data is more comprehensive because the IRS includes about twice the number of sponsoring organizations. However, many of the organizations covered by the IRS (and likely not included in NPT data) are small sponsoring organizations.

out zero, the aggregate payout would be 20%.<sup>122</sup> In other words, donors that distribute little to no money to charity from their DAFs would be able to free ride on the high payouts of other donors.

Payout should be at the fund level for straightforward reasons. Donors that create DAFs and do not advise a payout, or pay out very slowly, are the main reason for requiring a payout. These are the donors that most need a push to distribute funds to charity and who, for whatever reason, are indecisive. The ability to use a DAF may be a benefit to the indecisive donor, but the law should not tolerate unlimited indecision. The point of the DAF is to distribute the money to a charity that can use it.

Further, a mandated fund-based payout would standardize expectations for NSOs and donors and end disputes about how payouts are calculated and whether payouts are high enough. For DAFs that already pay out at a high level, a mandate would not change behavior. For DAFs that do not make substantial payouts, a mandate would accelerate distributions, which would achieve the desired outcome.

Moreover, if the payout is objectionable to these donors, then what are the consequences? One is that the donor instead funds a private foundation—but this is not necessarily a bad outcome. If the donor's motives are to establish a perpetual institution, then the foundation is the appropriate form.<sup>123</sup> Some might argue that donors should not be encouraged to incur the expense of a private foundation, especially if the main attraction of DAFs is their use as an alternative to private foundations.<sup>124</sup> But, as discussed earlier, to the extent DAFs are used as private foundation substitutes, the DAF represents a loophole, which a high payout would close. In addition, some, perhaps many, donors that now object to a payout might, once a payout is the law, accept it as

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122. The payout would be determined by dividing total distributions (\$2 million) by the beginning of the year value (\$10 million). This is the same payout formula used by the IRS and the National Philanthropic Trust. *Id.* Fidelity uses a different formula to determine payout: distributions for the year divided by the average aggregate asset value of the previous five years. Given the high growth of Fidelity DAF funds over this period, a five-year average asset value has the effect of shrinking the denominator and making aggregate payout appear larger.

123. Another possible alternative is that the donor instead contributes to a DAF at a community foundation. In-depth discussion of how community foundations may be distinguished from national sponsoring organizations is outside the scope of this Article but is an important issue.

124. The Treasury Department noted that “[a]necdotal reports suggest that some smaller private foundations are being advised to consider choosing to ‘reorganize’ as DAFs by transferring all assets to a DAF and terminating the private foundation.” TREASURY REPORT *supra* note 5, at 29. A spend down of assets need not mean an end to foundation conversions, but would change the calculation for small foundations, perhaps in a positive way. Foundations could trade for a less expensive and restrictive regulatory environment but give up perpetual life.



reasonable, along with the preferred tax status of the sponsoring organization over a private foundation.

Another possible consequence of a fund-based payout is that some donors might not give to charity at all. In other words, the payout could have the effect policymakers should seek to avoid—driving away new charitable donors and thus encouraging private consumption. But a donor's decision not to give because of a high fund-based payout also is not a bad outcome in this context. Under present law, the donor has taken a charitable deduction but is not distributing the money. The point of the DAF at an NSO should be to attract new charitable money and also to encourage donors to distribute it to charity. The DAF at an NSO is a charitable distribution vehicle—that is the basis for the sponsor's exemption. Donors should know when giving that perpetuity is not an option.

A final objection to a fund-based payout is that it would be an administrative burden on the sponsoring organization. Sponsoring organizations would have to calculate distribution requirements for each fund, inform donors of their obligations, and make distributions when donors fail to provide advice.<sup>125</sup> This would be a burden, and the costs would undoubtedly be passed on to donor accounts through higher administrative fees for account maintenance. Nevertheless, sponsoring organizations already have access to account balance information and the timing of contributions and distributions. Fidelity, for example, reports that “[m]ost contributions to Fidelity Charitable are granted out to charities within [ten] years, based on a first-in, first-out analysis of contributions and grants.”<sup>126</sup> It should be within the competence of these sophisticated financial intermediaries to track subaccount balances and payouts over time, without creating an undue burden.

An alternative to a payout would be to delay the charitable deduction until the DAF makes a distribution. Such an approach would in effect, treat the sponsoring organization as a conduit or agent, thus emphasizing substance over form. A similar approach has been used in other circumstances. For example, in one case, a charity designated a public utility as its authorized agent to collect voluntary contributions on the

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125. One approach might be for NSOs to maintain annual subaccounts for each donor. Contributions made during the year to the account would be added together and the account would be closed to additional contributions at the end of the year. The account (including any gains) then would be spent down within the spend-down period. A definition of a qualifying distribution also would be required, for example, to prevent distributions from one DAF to another DAF.

126. See FIDELITY 2015 REPORT, *supra* note 74, at 4.

charity's behalf from the utility's customers.<sup>127</sup> The utility exercised no dominion or control over the funds. The IRS held that the customers were allowed a charitable deduction in the year the utility paid the funds to the charity, not when the customer paid the funds to the utility.<sup>128</sup> Although NSOs do not act as authorized agents of the charities receiving distributions, NSOs again are on the edge—relying in large part on legal formalities for beneficial treatment.

Delaying the charitable deduction until the DAF distribution would likely be as effective as a payout, if not more so, at speeding up distributions. Indecisive donors generally would seek to accelerate deductions and reach a decision far more quickly than with a multi-year payout period. This approach, however, likely would have the effect of ending the main appeal of the DAF at NSOs—a current deduction but delayed decision.<sup>129</sup> Again, this is not necessarily a bad result, except to the extent that DAF contributions represent new giving.

DAFs at NSOs are now a proven fundraising vehicle. Policymakers should take steps to ensure that DAFs also become institutionalized as a charitable distribution vehicle. Donors who are attracted by the convenience and efficiency of NSOs will not be deterred by a reasonable mandate to distribute deducted contributions over an appropriate period. Donors who are deterred have other giving choices. Donors who choose not to give are the donors who probably should not be receiving federal income tax deductions for DAF contributions in any event. In short, NSOs should be welcomed as a tool to promote a culture of giving, but the welcome should be at arm's length.

#### IV. A NET-BENEFIT APPROACH FOR NONCASH ASSET CONTRIBUTIONS

##### A. *The Broken System of Noncash Asset Donations and the Growing Role of DAFs*

The DAF is emerging as a key source of noncash charitable contributions. The Fidelity Charitable Gift fund reports that in 2015 two-thirds of Fidelity Charitable donor contributions were made with noncash assets,<sup>130</sup> “[n]early two-thirds of donors set up or use their

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127. Rev. Rul. 85-184, 1985-2 C.B. 8.

128. *Id.*

129. Substantiation issues also would arise.

130. See FIDELITY 2016 REPORT, *supra* note 16, at 12.

DAFs to donate appreciated assets,”<sup>131</sup> and “[s]ince inception, Fidelity Charitable has assisted in converting [\$3] billion of illiquid assets into charitable dollars available for grants.”<sup>132</sup> The National Philanthropic Trust concurs, noting that: “contributing illiquid assets to donor-advised funds continues to be an increasingly popular trend . . . .”<sup>133</sup> and that donors are “utilizing assets . . . such as real estate, collections and limited partnerships.”<sup>134</sup> Policymakers should take note. DAFs present an opportunity to improve the current broken system of noncash contributions.

Charitable contributions of noncash assets (property) are a long-standing source of concern, for reasons that have nothing to do with donor advised funds. What began as a simple notion—a charitable deduction for donated assets—has become an immensely complicated cacophony of woefully nontransparent rules that are inefficient, inequitable, promote abusive transactions, harm the reputation of the nonprofit sector, and in many cases yield an uncertain benefit to charity. The issues range from matters of pure policy to administration and include: allowing a deduction for unrealized appreciation; uncertain valuation of donated assets; the net benefit that inures to charity (the donee); tax incentives that encourage property over cash contributions, and the sheer complexity of the rules, which undermines transparency and hinders compliance efforts for administrators and taxpayers alike.

Although it is beyond the scope of this Article to present each issue in detail,<sup>135</sup> a brief summary of the rules and issues raised may be helpful and is necessary to provide context. A simple example serves as a useful starting point. Assume that a donor owns 100 shares of publicly traded stock and donates the stock to a 501(c)(3) organization. At the time of the donation, the stock is trading at ten dollars a share. What is the donor’s deduction? The general rule is that a charitable deduction is allowed for property contributions equal to the fair market value of the property at the time of the contribution.<sup>136</sup> Thus, the deduction would be

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131. See FIDELITY 2015 REPORT, *supra* note 74, at 22.

132. See *id.* at 11; FIDELITY 2016 REPORT, *supra* note 16, at 12 (\$3 billion of illiquid assets in 2016 is an increase of \$600 million from \$2.4 billion in 2015).

133. See NPT 2014 REPORT, *supra* note 2, at 11.

134. See NPT 2015 REPORT, *supra* note 2, at 11.

135. For extensive discussion, see Roger Colinvaux, *Charitable Contributions of Property: A Broken System Reimagined*, 50 HARV. J. ON LEGIS. 263 (2013).

136. I.R.C. § 170(a) (2012); Treas. Reg. § 1.170A-1(c)(1) (as amended in 2011).

1,000 dollars.<sup>137</sup> This seems a reasonable result because the donor has parted with property worth 1,000 dollars. But what if the donor paid only one dollar for each share of stock, or 100 dollars total? If so, the donor is allowed a 1000 dollar deduction (to shelter wage income) even though the tax cost of the property was just 100 dollars. This ability to deduct unrealized (i.e., untaxed) appreciation has been widely condemned.<sup>138</sup>

In addition, what if within days of the donation, the stock value plunges 65%? Worried about further devaluation of the stock, the donee charity sells the stock for 350 dollars. Does the amount of the deduction change? No, the deduction is based on date-of-contribution value of 1,000 dollars, not date of sale value.<sup>139</sup> This too may seem reasonable. Someone has to bear the risk of loss. Since the donor has parted with legal control of the asset, the risk of loss should pass to the donee as an incident of ownership. On the other hand, it is not just the charity that bears the risk of loss, but taxpayers generally. The taxpayers, through the charitable deduction, have subsidized a gift of 1,000 dollars. If the actual benefit to charity is less than 1,000 dollars, taxpayers bear some of the burden by in effect overpaying for the donation.<sup>140</sup>

What if instead of publicly traded stock, the donor contributes illiquid property, like privately traded securities or real estate? Now, the rules diverge based on the type of donee organization. If the illiquid property is donated to a (non-operating) private foundation, then the deduction is limited to the donor's cost basis, i.e., the donor is not allowed to deduct unrealized appreciation, and thus neither of the two issues above matter.<sup>141</sup> If the illiquid property is donated to a public charity, then as

137. If the donor held the property for one year or less, then the deduction is equal to the donor's cost basis in the stock. I.R.C. § 170(e)(1)(A).

138. Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687, 720 (1999) ("inefficient and unfair"); Wendy C. Gerzog, *From the Greedy to the Needy*, 87 OR. L. REV. 1133, 1158 (2008) ("inequitable"); Daniel Halperin, *A Charitable Contribution of Appreciated Property and the Realization of Built-in Gains*, 56 TAX L. REV. 1, 4 (2002) ("inequitable"); Calvin H. Johnson, *Ain't Charity: Disallowing Deductions for Kept Resources*, 128 TAX NOTES 545, 549 (2010) (a "mistake"); Richard Schmalbeck, *Gifts and the Income Tax—An Enduring Puzzle*, 73 L. & CONTEMP. PROBS. 63, 89 (2010) ("a clear error"); see also Harvey P. Dale & Roger Colinvau, *The Charitable Contributions Deduction: Federal Tax Rules*, 68 TAX L. 331, 359 (2015) (noting that in 2011, 41% of noncash contributions were claimed by individuals earning \$1 million or more of adjusted gross income, or .747% of total returns).

139. I.R.C. § 170(a), (e) (2012); Treas. Reg. § 1.170A-1(c)(1).

140. In this (admittedly dramatic) example, if the donor is in the 39.6% tax bracket, the donor takes a \$1000 deduction, which is worth \$396 to the donor. The charity gets \$350, meaning that it cost the federal government \$396 to deliver \$350 to charity.

141. I.R.C. § 170(e)(1)(B)(ii). If the illiquid property is depreciated (i.e., has a value less than the donor's basis), then the deduction is fair market value and valuation still is a concern.

before, the donor is allowed to deduct unrealized appreciation based on the date of contribution value.<sup>142</sup>

In addition, unlike with publicly traded stock, illiquid assets raise the stakes of relying on date of contribution value to determine the amount of the deduction. The value of publicly traded stock, though variable from day to day, at least is based on exchange value—a verifiable amount equal to what buyers and sellers pay in market-based arm’s length transactions. By contrast, illiquid assets do not have a similarly objective measure for value. Unlike in a market transaction, where buyers and sellers negotiate a value and a price, in a donative transaction, market pressure is absent. Instead, the value of illiquid assets must be determined by third-party appraisers, hired by the donor. The donor has an incentive to inflate the value (because it leads to a higher deduction). The donee is not responsible for valuing the asset, and generally has an institutional interest in not challenging donor valuations (so as not to alienate donors). Further, the donee also generally benefits from a higher valuation, which increases on paper the amount of public support received by the donee.

In short, in a donative transaction of illiquid assets to a public charity, the principal check on valuation abuse is the Internal Revenue Service.<sup>143</sup> For the IRS effectively to police property contributions is a daunting task. Many overvaluations will go unchallenged. And challenges, when mounted, are time consuming and expensive.<sup>144</sup> The inherent uncertainty in valuation adds to the cost of the donation—in administrative time and expense, and by overpaying for the subsidy.

Further, the cost of the donation should be viewed not just from the perspective of the tax system and the public fisc, but also from the donee’s perspective. Accepting property donations is not costless. Donees incur carrying costs (maintenance, insurance, etc.) and expenses related to sale. This again raises an incongruity between the net benefit to charity from a donation, and the amount allowed as a deduction, which again, is based on an uncertain date of contribution value.<sup>145</sup>

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142. An appraisal is required. The appraisal must be dated no earlier than sixty days before the contribution and no later than the due date for filing the return. Treas. Reg. § 1.170A-13(c)(3).

143. The secondary check on valuation is the integrity of the appraisal process. The regulations define appraisal standards. In addition, there are penalties on donors (and appraisers) for overvaluation, all in an effort to get to an accurate value of contributed property. I.R.C. §§ 6662, 6695A .

144. For extensive discussion, see Colinvaux *supra* note 135, at 282–89.

145. The industry relating to processing noncash contributions is substantial. Consider the website for Charitable Solutions, LLC, a “planned giving risk management consulting firm” that focuses on noncash asset receipt and disposition, among other services. The firm notes on its home

In addition, another set of rules applies if the property is tangible personal property, like clothing, household items, collectibles, or artwork. If this type of property is given to a private foundation, the donor is limited to a deduction of basis (unless the property is worth less than the donor's basis, in which case the deduction is the fair-market value of the property).<sup>146</sup> If made to a public charity, a fair-market value deduction is allowed if the property is for the donee's use in exempt programs (known as a "related use").<sup>147</sup> Otherwise, the deduction is limited to the donor's basis.<sup>148</sup> In addition, special rules exist for certain types of tangible personal property (vehicles, fractional interests of artwork, taxidermy) adding to the overall complexity.<sup>149</sup> There are also distinct rules for contributions of inventory and intangible property.<sup>150</sup>

The DAF enters this array of rules as a magnet for noncash contributions of all kinds, but especially of illiquid assets.<sup>151</sup> As a public charity, contributions to DAF sponsoring organizations receive the more favorable treatment—the ability to deduct unrealized appreciation<sup>152</sup>—than the same contribution to a private foundation.<sup>153</sup> This is one reason to believe that for some contributions, donors may use a DAF instead of a private foundation.<sup>154</sup>

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page that noncash donations are one of only "two types of gifts in which a charity can actually lose more money than the original gift." The firm has a relationship with the Dechomai Foundation, which "assists charitable organizations and donors in the often-daunting process of receiving, managing, liquidating and finally granting proceeds from non-cash donations." *The Dechomai Foundation*, DECHOMAI, [www.dechomai.org](http://www.dechomai.org) [<https://perma.cc/GV3H-Q3ZU>]; see also *Charitable Solutions LLC*, CHARITABLE SOLUTIONS [www.charitablesolutionsllc.com](http://www.charitablesolutionsllc.com) [<https://perma.cc/VBB2-WA84>].

146. I.R.C. § 170(e)(1)(B)(i).

147. *Id.* § 170(e)(1)(B)(i)(D).

148. As with private foundations, if the property is worth less than the donor's basis, the deduction is fair market value.

149. I.R.C. § 170(e)(1)(B)(iv); *id.* § 170(f)(12); *id.* § 170(o).

150. *Id.* § 170(e)(3); *id.* § 170(m).

151. Fidelity reports that "[t]hree-quarters of donors say the ability to donate [noncash] assets is a reason they set up or use a donor-advised fund" FIDELITY 2015 REPORT *supra* note 74, at 4.

152. Fidelity reports that 78% of donors use or set up a DAF "[t]o potentially minimize capital gains taxes." *Id.* at 22.

153. Property contributions to public charities also are subject to a more generous cap (30% of adjusted gross income) than property contributions to private foundations (20% of adjusted gross income). I.R.C. § 170(b) (2012).

154. In general, for tax planning purposes, it would make sense to give cash and public securities to the private foundation and illiquid assets to the DAF. The DAF then could fund the same causes as the private foundation (under the donor's name), and the private foundation could make distributions to the DAF in satisfaction of the foundation's payout requirement (DAFs are subject to the excess business holdings rules, meaning that they cannot be used to avoid this aspect of the private foundation regime.).

As one example, in marketing materials Fidelity relays the experience of a donor who was preparing to sell his interest in a privately held company:

I wanted to create an ongoing charitable concern, something to serve as a legacy for me and my whole family. I thought first of establishing a private foundation, but found there were two problems: one, that donating privately held stock to a private foundation is not a tax-efficient option; and two, that the administrative challenges were considerable and expensive. Establishing a DAF at the Fidelity Charitable Gift Fund was absolutely the best option.<sup>155</sup>

Apart from tax advantages, which sponsoring organizations share with any other public charity, sponsoring organizations market themselves as the more efficient vehicle for converting complex assets into cash, and increasing the net benefit to charity. Again, according to Fidelity:

Many nonprofit organizations, being primarily mission- and program-focused, are not well equipped to handle this type of contribution [(non-publicly traded assets)] . . . . Furthermore, while some charitable organizations might have some limited experience in handling contributions of complex assets, *the cost to the charity to outsource the compliance and liquidation work can be considerable*. Although the donor would still be eligible to claim a fair market value deduction, *the net result to the charity would once again be significantly reduced* . . . . In many cases, an optimal method for donating complex assets to charity—measured by cost, flexibility, simplicity, and tax benefits to the donor, as well as by maximizing the net proceeds ultimately made available to charitable organizations—is to make the contribution to a charity that offers donor[ ]advised funds.<sup>156</sup>

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155. Karla D'Alleva Valas, *Donating Complex Assets to Charity*, FIDELITY CHARITABLE, <http://www.fidelitycharitable.org/giving-strategies/tax-estate-planning/donate-non-publicly-traded-assets.shtml> [https://perma.cc/9TE6-FXFJ].

156. *Id.* (emphasis added). The other major national gift funds have similar materials. Ann Gill, *Donating Illiquid Assets: Non-Publicly Traded Stock*, VANGUARD CHARITABLE (May 20, 2015), [https://www.vanguardcharitable.org/blog/blog\\_donating\\_illiquid\\_assets\\_non\\_publicly\\_traded\\_stock/](https://www.vanguardcharitable.org/blog/blog_donating_illiquid_assets_non_publicly_traded_stock/) [https://perma.cc/65A4-RWWT] (“Many charities—especially small to mid-sized ones—do not have the resources to accept this type of asset.”); Barbara Benware, *Why it Might Make Sense to Donate Your Best Investments Instead of Cash: Appreciated Assets Can Be Among the Most Tax-Advantaged Items to Contribute to Charity*, SCHWAB CHARITABLE, <https://www.schwabcharitable.org/public/file/P-5260825> [https://perma.cc/D843-PXM7] (“Unfortunately, not all charities have the resources or capabilities to accept gifts of appreciated investments directly. That’s

In other words, Fidelity argues that donors with complex assets *should*, as a matter of public interest, give to a DAF instead of another public charity. Other public charities are not in the business of buying and selling assets and so will drive up the costs of the transaction, resulting in less benefit to charity. It is much better, Fidelity says, to give the asset to a DAF sponsoring organization, have the sponsoring organization sell the asset, and then distribute the proceeds to charity from the donor's DAF account—less “any applicable unrelated business income tax[,] . . . actual carrying and maintenance costs, and certain tax preparation consultancy costs,”<sup>157</sup> which are taken from the proceeds of the sale. In either case, the donor's deduction will be the same—and based on the date of contribution value. But if a DAF is used, the amount actually distributed to a “mission” or “program” focused charity will be greater.

The marketing materials are suggestive. Clearly, sponsoring organizations are competing for the noncash contribution business,<sup>158</sup> indicating that many DAF contributions are substitutes (both for other public charity gifts, and private foundation giving), not new giving. More important though is the likely trend: “Until recently, non-publicly traded assets *were a largely untapped source of philanthropic funding*, in part because these assets can be complicated for individuals to give and for some nonprofits to accept.”<sup>159</sup>

As a hint of untapped sources of funding to come, Fidelity cites to a report by Deloitte Consulting, which states that: “the top 1% of all U.S. households hold 36% of their wealth in privately held businesses.”<sup>160</sup> In short, Fidelity believes that the DAF is the uniquely appropriate vehicle

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where donor-advised fund accounts can come in handy. These charitable accounts . . . allow you to more easily convert appreciated investments into tax-effective charitable contributions. This is because the sponsoring charity may have more experience with these types of gifts and can be in a better position to evaluate prospective contributions of appreciated property and liquidate the property once it is donated.”); *Illiquid Asset Contribution Guidelines*, NAT'L PHILANTHROPIC TRUST, <http://www.nptrust.org/daf-forms/Illiquid-Asset-Contribution-Guidelines.pdf> [https://perma.cc/VB5M-CK3V].

157. D'Alleva Valas, *supra* note 155. Other gift funds have similar models.

158. The Fidelity materials say that the mission-driven public charity “might require that a donor first sell the assets and contribute the proceeds. A donor in this situation would have taxable income and thus would not, in most cases, choose to donate the entire amount of the proceeds . . .” *Id.*

159. See FIDELITY 2015 REPORT, *supra* note at 74, at 11 (emphasis added).

160. *Id.* (citing *The Next Decade in Global Giving Among Millionaire Households*, DELOITTE CONSULTING, LLP (2011)).



for attracting new charitable contributions of complex assets, and that the potential market is significant.<sup>161</sup>

Further, the target property is varied. In *The Art of Donating Property*, Vanguard Charitable promotes the contributions of “fine art, real estate, vehicles, and other illiquid assets.”<sup>162</sup> In “Donating Complex Assets for Charitable Giving” Vanguard Charitable lists a number of primary asset types, including non-publicly traded stock, an LLC or LLP interest, private equity, hedge fund interest, restricted stock, insurance policy, and “other.”<sup>163</sup> Schwab Charitable has a similar list, with the addition of “collectibles and artwork.”<sup>164</sup> The Boston Foundation noted the gift of a share in a cruise ship.<sup>165</sup>

The push by sponsoring organizations, especially NSOs, for noncash contributions raises another legal question regarding their 501(c)(3) status. As already discussed, NSOs as primarily fundraising organizations are at the edge of 501(c)(3) exempt status. As little more than a holding company, an NSO must avoid characterization as a feeder organization,<sup>166</sup> spend in accordance with its resources, and must remain vigilant against private benefit and inurement from relationships with

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161. Of total contributions to Fidelity in 2014, 9% were of non-publicly traded assets, 46% were publicly traded securities, and 45% cash. FIDELITY 2015 REPORT, *supra* note at 74, at 11. Fidelity is not alone in this belief, as the marketing materials of other sponsoring organizations suggest.

162. Ann Gill, *The Art of Donating Property*, VANGUARD CHARITABLE (February 25, 2015), [https://www.vanguardcharitable.org/blog/blog\\_the\\_art\\_of\\_donating\\_property/](https://www.vanguardcharitable.org/blog/blog_the_art_of_donating_property/) [<https://perma.cc/296W-2WQX>].

163. *Donating Complex Assets for Charitable Giving*, VANGUARD CHARITABLE, [https://www.vanguardcharitable.org/individuals/make\\_a\\_contribution/special\\_assets](https://www.vanguardcharitable.org/individuals/make_a_contribution/special_assets) [<https://perma.cc/8VKE-REF7>].

164. *See* Benware, *supra* note 156. *See also, supra* note 117. The donation of art and collectibles that are worth less than the donor's basis are deductible at fair market value. Although valuation is a concern, donors are not able to deduct unrealized appreciation. If the property is appreciated property, however, then a fair market value deduction is allowed (i.e., donors may deduct unrealized appreciation) only if the property is for the related use of the donee. Some sponsoring organizations may be using other intermediaries to satisfy the related use test. *See* Gill, *supra* note 162. In *The Art of Donating Property*, Gill describes one donation of fine art, where Vanguard partnered with a for-profit company and a related foundation to process the art donation and transfer the proceeds to the donor's DAF at Vanguard. The details are not clear—but illustrate the fact that multiple entities can be involved—perhaps for tax planning purposes.

165. *Valuing Non-Cash Assets for Charity: What Donors Need to Know*, BOSTON FOUND., <http://www.tbf.org/tbf/65/complex-assets> [<https://perma.cc/5BQB-DAUC>] (noting that “[t]he Internal Revenue Service requires that [non-cash] assets be valued, a sometimes difficult task for things like illiquid company stock, land, privately held corporations or anything else not price by a public market”).

166. As noted in note 99, *supra*, an organization that conducts a for-profit business and turns all profits to charity is classified as a feeder organization and ineligible for 501(c)(3) status. I.R.C. § 502.

affiliated for-profit investment firms. A deepening involvement in managing complex asset donations further muddies the waters.

For example, in two private letter rulings, the IRS considered and rejected the 501(c)(3) status of organizations that were formed to facilitate donations of noncash property. In a 2005 ruling, an organization sought exemption as “a facilitator to contributors who want to donate tangible personal property, such as boats, to a charity that the donors designate.”<sup>167</sup> The IRS said that:

Arranging for donors for the charitable contribution of their boats, by taking possession and title to the boats; by arranging with third parties for their moorage, for necessary repairs and upgrades, and for sales by brokers; and by paying the net sales proceeds to the charity designated by the donor, all constitute common commercial activities, rather than activities that further a charitable purpose.<sup>168</sup>

The IRS concluded that the organization was “organized and operated for the primary purpose of carrying on an unrelated trade or business[ ],” i.e., a feeder organization.<sup>169</sup> Similarly, in a 2008 ruling the question raised was: “Does an organization formed to facilitate donations of real estate qualify for exemption”<sup>170</sup> under section 501(c)(3)? The IRS said that “[t]he facilitation of real estate transactions through for-profit third party entities for a fee constitutes a trade or business ordinarily carried on for profit.”<sup>171</sup>

On the surface, the comparison of these failed 501(c)(3) organizations to sponsoring organizations is obvious. Sponsoring organizations are engaged in the same basic activities as the organizations in the rulings—liquidating property. But there are important possible distinctions. A key conclusion for the IRS in both rulings was that the organizations were deemed to be the agents of the donor, which imbued the sales activity with more of a commercial hue.<sup>172</sup> Thus, the organization was judged to be providing commercial services for the donor (and also, incidentally, would have sheltered the donor from capital gains taxes). Whether sponsoring organizations can be characterized as agents for their donors returns to the essential nature of “donor advice” in the DAF context.

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167. I.R.S. Priv. Ltr. Rul. 200512027 (Mar. 25, 2005).

168. *Id.*

169. *Id.*

170. I.R.S. Priv. Ltr. Rul. 200825051 (June 20, 2008).

171. *Id.*

172. *Id.*; I.R.S. Priv. Ltr. Rul. 200512027 (Mar. 25, 2005).

Another distinction is that the organizations in the rulings did not engage in other activities.<sup>173</sup> Sponsoring organizations are not exclusively in the noncash asset business. But as this business increasingly becomes a primary activity, if it is not already,<sup>174</sup> the charitable purposes of sponsoring organizations will again be called into question.

All of this leads to questions about how policymakers should respond to the increasing use of sponsoring organizations to process noncash charitable contributions. As the sponsoring organizations state, there are reasons to think that they are a more efficient vehicle than other public charities for accepting many kinds of noncash contributions, especially illiquid assets. Because sponsoring organizations specialize in the liquidation of complex assets, they are better positioned to reduce transaction costs, potentially making more cash available to mission-driven charities.

In addition, the ability to liquidate a complex asset for the benefit of multiple charities is also an attractive feature of using a DAF in this context. Without a DAF, the contribution of indivisible property must go to a single charity (if tax benefits are to be preserved).<sup>175</sup> Further, because many mission-driven charities are not in a good position to accept and dispose of complex assets, the market for complex asset donations is likely depressed.<sup>176</sup> The sophistication offered by many sponsoring organizations likely does represent an opportunity to release an “untapped” source of charitable contributions.<sup>177</sup>

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173. The extent to which sponsoring organizations rely on for-profit firms to process transactions may also be a distinction. Schwab says that it accepts noncash assets “via a charitable intermediary, with proceeds of your donation transferred to your donor-advised account upon liquidation.” SCHWAB CHARITABLE, *supra* note 117, at 4 (fine print).

174. Fidelity in 2014 received more contributions in noncash assets than cash. FIDELITY 2015 REPORT, *supra* note 74, at 11.

175. SHERLOCK & GRAVELLE, *supra* note 8, at 3 (noting that a “DAF can permit the contribution of a large indivisible appreciated property such as real estate. When property is not divisible, the contribution cannot be spread across many charitable donors or donated over time”).

176. *Non-Cash Donations*, CHARITABLE SOLUTIONS, <http://charitablesolutionsllc.com/non-cash-donations/> [<https://perma.cc/JS7F-VHLU>] (noting that charities sometimes refuse gifts because they lack expertise, time or staff).

177. See Lewis B. Cullman, *The Charitable Funds that Benefit Rich Donors and the Financial Industry*, PBS NEWSHOUR (Aug. 15, 2016), <http://www.pbs.org/newshour/making-sense/raw-deal-taxpayer-donor-advised-funds-becoming-americas-largest-charities/> [<https://perma.cc/L5ST-CZ4P>] (noting that “[o]ne proponent of DAFs has referred to this exploitation of previously untapped resources as ‘philanthropic fracking’”). This strengthens the case that here, donor advised funds may be vehicles for giving that would otherwise not occur, but only to the extent that donors of complex assets do not reduce other contributions.

On the other hand, as yet more complex, and inherently difficult-to-value assets are contributed, the opportunities for abuse will multiply, as will administrative costs, overpayments of the subsidy by the federal government, and equitable concerns that the deduction favors the wealthiest. The charitable deduction already is claimed disproportionately by those at the very top of the income distribution.<sup>178</sup> DAFs, by providing a lucrative deduction for the top 1%,<sup>179</sup> will put further pressure on the charitable deduction generally.

*B. A Net-Benefit-to-Charity Approach to Noncash Assets*

Congress could respond in any number of ways. Least attractive is to do nothing. As outlined above, the system for property contributions is broken, notwithstanding some positive features of using DAFs in this context.<sup>180</sup> So, some response is warranted.

To fashion a response, Congress should begin by taking note of first principles. In theory, as a matter of income measurement, no charitable deduction should be allowed for unrealized appreciation.<sup>181</sup> The ability to deduct unrealized appreciation is no more and no less than a subsidy, the presumed intent of which is to encourage asset owners to transfer wealth to charity. To be sure, it is a longstanding and popular subsidy, but also one that is about to get more expensive with the rise of DAFs. DAFs thus provide an opening to question whether to keep the subsidy at all.<sup>182</sup>

For purposes of this Article, it is assumed that policymakers want to continue to subsidize noncash charitable contributions.<sup>183</sup> Nonetheless,

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178. See HUSOCK, *supra* note 84.

179. See Siegel, *supra* note 100.

180. As noted above, however, as sponsoring organizations become more deeply engaged in the business of selling assets, the more doubt is cast on exempt status. Unrelated business income tax issues are could arise.

181. William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 372 (1972); see also HUSOCK, *supra* note 84.

182. STAFF OF JUDICIAL COMM. ON TAXATION, 109TH CONG., OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 293–307 (Comm. Print 2005) (recommending elimination of the subsidy); see Halperin, *supra* note 138 (arguing for a constructive realization of gain upon contribution). The author has argued elsewhere that the charitable deduction for property contributions should be viewed as a distinct tax expenditure with high tangible and intangible costs. See Colinvaux, *supra* note 135. The Article argues that if a charitable contribution for property is allowed, it should be only in cases where there is a measurable benefit to charity.

183. *But see A Bill to Amend the Internal Revenue Code of 1986 to Provide for Comprehensive Tax Reform: Hearing on H.R. 1 Before the H. Comm. On Ways and Means*, 113th Cong. Sess. 2 (Dec. 10, 2014) (introduced by Dave Camp) (ending the ability to deduct unrealized appreciation for real estate and privately held securities).

with DAFs, tolerance for a deduction determined by an appraised value may finally be untenable. Sponsoring organizations operate complex donation programs primarily to liquidate donated property to cash. With a system emerging in the marketplace for intermediaries to accept and liquidate noncash property, there is a strong case that a deduction, if allowed, should be based on the net benefit to charity (i.e., the amount made available for distribution from the donor advised fund), not the appraised amount. Thus, Congress should take the rise of the DAF giving vehicle as an opportunity to improve the system for noncash contributions (i.e., not just contributions to DAFs but to any charity) by reducing the costs of the subsidy and moving to a “net benefit to charity” approach to the deduction.

A net-benefit-to-charity approach for the deduction aligns the deduction with the amount that goes to the (active) charity. As a result, donee organizations would have incentives to reduce transaction costs in order to maximize donor deductions. Donors would be more likely to give noncash assets to donee organizations that have the most efficient liquidation programs (meaning, in many cases, sponsoring organizations). If property does not sell for as much as donors hope or anticipate, the government (and so other taxpayers) will not be shortchanged by overpaying for the contribution.<sup>184</sup> Further, the net benefit to charity approach is not new, but is used in the context of vehicles<sup>185</sup> and intellectual property.<sup>186</sup>

That said, a net-benefit-to-charity approach would raise a number of issues. What is the deduction if the donee does not sell the property? Should there be a forced sale rule? Should the net-benefit approach apply to all noncash assets or only those where valuation is a problem, or assets above a minimum value? Should there continue to be special rules for related use property? These are all important questions that would require answers once there is agreement to move to a net benefit approach.

To see how a net-benefit approach might work, one general rule (the “Rule”) could be that the deduction for contributions of noncash assets to a public charity is equal to the lesser of: (1) the donor’s basis in the property plus one half of the appreciation (the “Initial Amount”); or (2)

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184. See, e.g., *Illiquid Asset Contribution Guidelines*, NAT’L PHILANTHROPIC TRUST, *supra* note 156 (cautioning donors that “[d]ue to the amount of time required to liquidate the asset, sales proceeds may differ from the appraised or fair market value at the time of the contribution”).

185. I.R.C. § 170(f)(12) (2012) (basing amount of deduction for vehicles on sales price).

186. *Id.* §§ 170(e)(1)(B)(iii), (m) (allowing an initial deduction of basis, to increase in later years based on income from the contribution to the donee).

the net benefit to charity. The net benefit to charity would be determined based on: (1) in the case of a contribution to a sponsoring organization, the amount made available for distribution from the DAF by donor advice; or (2) in the case of another public charity, the net sales proceeds. In the case of depreciated property, the Initial Amount would be the fair market value. The deduction could be allowed in the year of contribution, subject to recapture in the year the net benefit to charity can be determined, with a limit on recapture of a specified period from the contribution date. Although the Initial Amount of the subsidy (basis plus one-half the appreciation) may seem arbitrary, it is no less arbitrary in this context than fair market value, just not as generous. Further, the Initial Amount already is used as the allowable amount for certain contributions of inventory, and so has some precedent.<sup>187</sup>

The Rule could be applied to any type of noncash asset, with appropriate adjustments. Applying the Rule to publicly traded securities, the amount of the deduction would be reduced from the exchange value (present law) to the exchange value less one-half of the appreciation.<sup>188</sup> Donors would still be able to deduct some of the appreciation in the property (i.e., the subsidy would not be eliminated), but not all. If the donee sold the securities for less than the Initial Amount, then the amount of the deduction would be reduced accordingly. If the contribution and sale occur in the same tax year of the donor, then no recapture would be required.<sup>189</sup> For publicly traded securities, the limit on recapture could be one year after the contribution date, meaning that if the donee sold the securities more than one year later, there would be no recapture and the donor's deduction would be the initial amount (basis plus one-half of the appreciation).

Applying the Rule to illiquid noncash assets like real estate and privately held securities,<sup>190</sup> the Initial Amount would be the donor's basis plus one-half of the appreciation based on the appraised value. In general, the recapture period for illiquid assets should be longer than one year to account for the additional time it may take to dispose of the property. The net benefit to charity would be determined by reducing the

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187. *Id.* § 170(e)(3) (2016).

188. Some might argue that there is no reason to apply the rule to publicly traded assets, because valuation is not a problem. The reason to reduce the subsidy for the contribution of publicly traded assets is not to curtail abuse, but simply to reduce the cost of a generous subsidy.

189. As a practical matter, to avoid recapture and close the transaction, many donees would sell the property in the year of contribution. Non-sponsoring organization donees that prefer to retain the securities could do so, and the donor's deduction would be fixed at the initial amount.

190. Some publicly traded securities could fall into this category if the securities were subject to substantial restrictions.

sales proceeds by the costs associated with carrying and selling the property. Sponsoring organizations already make similar calculations in determining how much to charge each DAF for the contribution.<sup>191</sup> The principal difference, then, is a reduction in the amount of the deduction from full-appraised value to the Initial Amount, not to exceed the net benefit to charity.

Applying the Rule to tangible personal property requires some additional consideration. As noted, the general rule is that, for appreciated property, the deduction is the donor's basis unless the property is for the related use of the donee.<sup>192</sup> In general, contributions to a sponsoring organization will not be for a related use, so already the allowable amount is just the donor's basis.<sup>193</sup> The Rule should not be applied to increase the deduction.

Otherwise, the question is whether the subsidy should be reduced from appraised value to the Initial Amount for related-use property. A full discussion is outside the scope of this Article,<sup>194</sup> but as an initial matter, related-use property should not be treated differently from other property. For tangible personal property that is depreciated, the Rule might apply only to items of property with a minimum value;<sup>195</sup> otherwise a net benefit to charity calculation might not be feasible.<sup>196</sup>

Over decades, Congress has wrestled with the correct deduction amount for charitable contributions of noncash assets, resulting in a multitude of scenarios.<sup>197</sup> DAFs present Congress with an opportunity

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191. Non-sponsoring organization public charities would have to track these amounts.

192. I.R.C. § 170(e)(1)(B)(i) (2012).

193. If a sponsoring organization accepted property it intended to use in a charitable activity related to its exempt purpose, then a fair market value deduction would be available. But as discussed, sponsoring organizations typically accept property not to use, but to liquidate.

194. Related use property presents a slightly different challenge from other property. The main issue is that the subsidy here is, or should be, intended to deliver a specific type of property to charity (e.g., art to an art museum). The question then is the efficient level of the subsidy for the particular market.

195. As noted *supra*, sponsoring organizations actively solicit tangible personal property like collectibles and artwork. See also NPT 2014 REPORT, *supra* note 2, at 11 (noting that many sponsoring organizations "are willing to accept . . . real estate and tangible personal property. Typically, [they] liquidate them relatively quickly . . ."). Sponsoring organizations also generally require a minimum value for complex assets. Thus, applying a net benefit to charity approach should not impose a significant new burden on sponsoring organizations, which already screen for appropriate contributions and track costs.

196. Low value clothing and household items are an example. Donor advised funds appear to be used rarely for this type of property, however, leaving a more fulsome discussion for other occasions. TREASURY REPORT *supra* note 5, at 61 (reporting a total of 142 donations in 2005 of clothing and household items, with a total value of \$129,000, all at community foundations).

197. See *supra* notes 135–50 and accompanying text.

both to embrace the vehicle as an efficient mechanism for converting complex assets to cash for the benefit of charity, and also to improve the system of noncash contributions and reduce its many costs.

## CONCLUSION

Donor advised funds attract a significant share of charitable giving, are growing rapidly, and warrant the attention of policymakers. The DAF is hard to conceptualize. The different types of DAF sponsors and the different reasons donors give make it difficult to design a regulatory approach for all DAFs. Important considerations are that contributions to DAFs are substitutes for giving to other public charities and private foundations but also represent new gifts.

The national sponsoring organization emerges as distinct from other sponsors. The exempt purpose of the NSO is to spend money for the benefit of other 501(c)(3) organizations and is best characterized as a fundraising organization. Given the NSO's exempt purpose, the NSO already is subject to a facts-and-circumstances-based payout—the commensurate in scope test. Because NSOs fundamentally are vehicles for spending, not saving, the IRS by regulation, or Congress through legislation, should apply the commensurate in scope test and require that NSOs ensure contributed funds are distributed over a specified time period. The goal of the payout is to provide a distribution period long enough so as not to alienate new donors, but short enough so as not to unduly extend the delay to charity that results when DAFs are used as public charity substitutes.

Congress also should recognize that DAFs increasingly are used for noncash charitable contributions. The positive effect will be to make property conversions more efficient. The negative effect will be to accentuate an already-broken system of property contributions at great expense: increasing the cost of the subsidy, straining administration of the charitable deduction, and exacerbating equity concerns. Assuming that Congress intends to retain the subsidy for noncash contributions, Congress should use DAFs as an opportunity to reduce the cost of the subsidy of the entire system (not just DAF contributions) and move to a net-benefit-to-charity approach to the deduction.