

Will Donor-Advised Funds Revolutionize Philanthropy?

C. Eugene Steuerle

Donor-advised funds may revolutionize philanthropy by facilitating the process of charitable giving. Many investment companies—and some trust companies—have begun to offer the funds, which allow individuals to give money to fund future charitable activity. Though the money is donated initially to the endowment for later distribution to charity, the donor is immediately eligible for a charitable contribution tax deduction.

Donor-advised funds are not entirely new: A similar device to set aside funds has been available for some time through such organizations as community foundations. Community foundations, however, have traditionally had contact with a limited number of citizens—nothing on the order of the tens of millions who own mutual fund assets. The mutual fund industry is popularizing the use of donor-advised funds for charitable purposes (see figure 1), and the community foundations are expanding their outreach as well.

As endowments set aside for charity, donor-advised funds have many similarities to foundations but do not face the same rules and restrictions that can intimidate would-be foundation donors. Donor-advised funds introduce a new ease to the establishment of endowments, calling into question the often burdensome policies associated with foundations.

Foundations Considered Tools for the Wealthy

Foundations have been regarded, rightly or wrongly, as organizations set up exclusively by wealthy individuals. This perception is reinforced in part by the difficulty of the tax laws that surround their establishment. Even if the complexity of these laws has been exaggerated, it still deters moderate givers. The law contains twists and turns and interlocking requirements. For example, a rule on required foundation payout rates is needlessly complex; an excise tax on investment income can actually penalize charitable activity; and the tabulation of income and expenses varies depending on whether items can be counted toward meeting some standard, such as the minimum payout.

The 990PF forms used to report annually to the Internal Revenue Service (IRS) are a nightmare for the uninitiated—and there are no simplified versions for small foundations that make only an occasional grant. The IRS has never taken even the most basic steps to ease the reporting process, such as electronic filing. Perhaps the one exception to this lack of help for the smaller endowment has been the attempt on the part of some organizations, such as The Investment Fund for Foundations (TIFF), to provide

As endowments set aside for charity, donor-advised funds have many similarities to foundations but do not face the same rules and restrictions that can intimidate would-be foundation donors.

smaller charities with the investment opportunities available to larger ones.

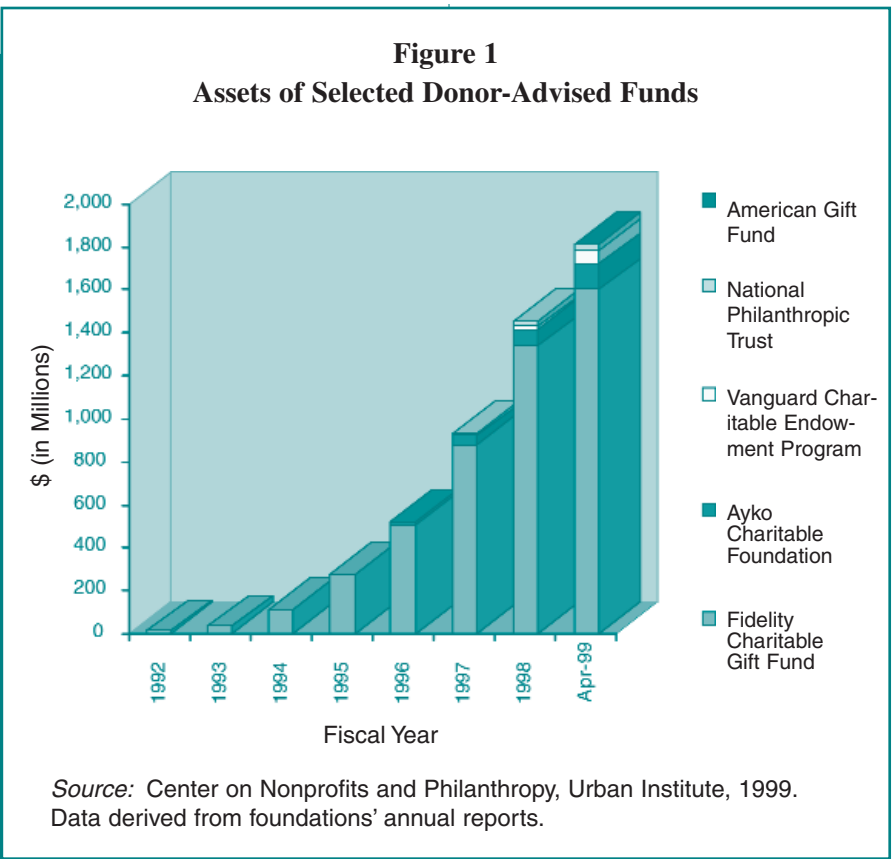
Because of the difficulty in establishing foundations, many financial advisers have recommended against forming them unless the amount to be given is substantial enough to make it worthwhile. The cost of advice alone, including legal and accounting fees, eats away at the foundation's potential charitable activities.

A New Democracy of Giving

The entry of the mutual fund industry into the realm of charitable endowments may democratize endowed giving by making it a manageable process for people of average means. Many donor-advised funds accept a minimum endowment of as little as \$25,000—a far cry from the hundreds of thousands thought by many to be needed for foundations.

With donor-advised funds, the mutual fund industry has not only pulled down many of the hurdles to setting up an endowment, it has shortened the track as well. Donor-advised funds have almost no filing requirements, and the few that exist are handled mainly by the mutual funds themselves. "Donor-advised funds," former IRS Commissioner Fred Goldberg stated, "...move very much in the direction of 'simplification' in the sense that they put record-keeping burdens, reporting burdens, on institutions that are more able to carry those responsibilities, and can achieve economies of scale and efficiency in discharging those responsibilities."¹ At the same time, the endowments avoid the excise tax on foundation investment income and minimum payout rates, although Fidelity and other investment companies may voluntarily ensure that some minimum is donated to charity.

The vast expansion of different forms of retirement plans, such as 401(k) plans, profit-sharing plans, and similar vehicles, makes it especially simple for an individual to transfer payments out of a plan directly into a



donor-advised fund. Once the endowment is set up, a transfer of money into the fund may require little more than a phone call to the mutual fund handling the retirement plan.

The democratization of endowment giving is an exciting prospect. It offers many possibilities for families who wish to pass giving habits down through generations. It simplifies the means by which individuals can set aside portions of their income for charitable purposes—hopefully encouraging a higher, more sustained rate of giving among individuals who might otherwise contribute inconsistently.

Overregulating Foundations

The regulations for foundations are complex and, more importantly, intimidating—a fact that has grown more obvious when the regulations on foundations have been compared with the simple regulations governing donor-advised funds. One of the most burdensome of the foundation regulations is the excise tax.

The tax was put into law with the stated intent, at least in some congressional documents, of financing the IRS's monitoring of the charitable sector. The money collected, however, has always been well in excess of the cost of all IRS monitoring efforts. Moreover, this money was never dedicated to the administrative function of the IRS's Employee Plans/Exempt Organizations operation but was instead transferred to general revenues. The recent IRS restructuring further unlinks this funding from its intended function.

In many ways, the excise tax violates standards of efficiency and equity and can only be understood as a penalty developed to punish the past abuses—real or perceived—of foundations. IRS officials, however, have given foundations high marks recently and have indicated that private foundations are less likely to be an area of the charitable sector requiring enforcement resources.

While the excise tax is not huge, it is a nuisance, especially for smaller foundations. It violates standards of

simplicity in taxation that call for limits on the number of taxes imposed by the state. The tax formula penalizes a foundation if it does not currently pay out a percentage of assets in excess of what it paid out in the recent past.² A foundation that temporarily sets a high payout rate is likely to pay a penalty if the rate is not maintained in the future.

The minimum payout rule, which requires an average of 5 percent of net worth to be donated annually, legally applies only to foundations. While anti-accumulation policies are useful—they deter foundations from forever building up their power relative to other institutions and ensure that charitable causes are served—their current design limits flexibility.

For example, accumulated assets could achieve a longer-term purpose. Funds that are built up over time could allow a lump sum, rather than a series of smaller contributions, to be donated. In addition, an endowment may want to see what a donee does with small contributions before donating a large amount of money. To provide such options, policymakers should consider modifying the traditional payout rule so it puts less emphasis on annual giving and more on long-term giving.

Current foundation practices that rely, correctly or not, on the minimum payout rule also tend to encourage increases in giving when the economy is strong and reductions when the economy is weak—just the opposite of what one might expect.

Regulating Donor-Advised Funds

Policymakers and financial institutions are grappling with how best to regulate donor-advised funds. For the sake of consistency, some suggest applying regulations traditionally designed for foundations, despite the fact that doing so might hinder the charitable potential of donor-advised funds.

Since the excise tax is hard to justify even for foundations, there is little case to be made (other than a legal bent

for consistency) for extending it to donor-advised funds. If Congress is not willing to get rid of this tax but wants to provide consistent treatment, it might extend the benefits of nontaxation to those foundations that resemble simpler donor-advised funds, allowing the type and degree of giving to determine the extent of regulation.

The success of donor-advised funds depends largely on whether or not the public trusts that these funds will not be abused. Some regulation will be necessary to achieve this trust. So while the debate about how to regulate donor-advised funds proceeds, the institutions offering the funds should take initial steps to minimize the possibility of abuse. The amount of future regulation can be minimized by setting standards now, so that when (and if) policymakers decide to act, they can simply refer to the reasonable practices already in place.

For example, some financial institutions (such as Fidelity) have voluntarily established an anti-accumulation policy, or payout rule, for donors as a group. At the same time, when the donations from one donor-advised fund can be mingled with those of another, there is significant leeway for any one donor-advised fund to keep a very low payout rate for a long period of time. Thus, the monitoring required to ensure that the donor-advised fund's flexibility is not abused may be provided by the private institutions themselves.

A more difficult regulatory issue sometimes raised is the inconsistent monitoring of the quality of the charitable organizations that are given donations. Community foundations often claim that they do more to assess a donee's worthiness than do mutual fund organizations, but not because it is required of them. The problem is that no one has developed a way to regulate screening that would not place an undue burden on charitable organizations.³ Finally, some filing requirements (such as lists of grants and contributions) need to be made uniform among foundations and donor-advised funds. But all

regulations should keep reporting to a reasonable minimum.

A New Way to Give

Donor-advised funds allow a wide range of people to establish small endowments—a development with exciting prospects for the future of philanthropy. However, donor-advised funds not only introduce a new way of giving, they also force a reevaluation of past practices. Because donor-advised funds are treated so differently from foundations on questions ranging from filing requirements to expenditure policies, we must take a closer look at regulations that may be hindering giving rather than encouraging it.

The development of donor-advised funds should not be pushed off course by a drive toward needlessly complex rules simply for the sake of consistency or by a laissez-faire attitude toward regulations that may encourage abuse or the perception of abuse. All parties involved—Congress, the Treasury, the IRS, private and community foundations, and the mutual fund industry—must work together to establish the balance between regulation and flexibility that nurtures the philanthropic potential of the nation.

Notes

This brief is based on “Economic Perspectives,” *Tax Notes*, January 4 and January 11, 1999.

1. See edited transcript of the July 31, 1998, American Bar Association (ABA) Exempt Organization Committee Meeting, Doc. 98-30340 or 98 TNT 198-45.

2. Steuerle, Eugene, and Martin Sullivan. Fall 1995. “Toward More Effective Giving: Reforming Tax Rules for Charitable Contributions and Charitable Organizations.” *American Journal of Tax Policy* 12 (2): 399–447.

3. For further detail on variations in practice, see comments by Victoria Bjorkland in the edited transcript of the July 31, 1998, ABA Exempt Organization Committee Meeting.


THE URBAN INSTITUTE

 2100 M Street, N.W.
 Washington, D.C. 20037

 Nonprofit Org.
 U.S. Postage
PAID
 Permit No. 8098
 Washington, D.C.

Address Service Requested

Telephone: (202) 833-7200 ■ Fax: (202) 429-0687 ■ E-Mail: paffairs@ui.urban.org ■ Web Site: <http://www.urban.org>

The Urban Institute's Center on Nonprofits and Philanthropy (CNP) was established in September 1996 to explore the role and contributions of nonprofit organizations in democratic societies. The work of CNP will be communicated through the dissemination of timely, nonpartisan research to policymakers, practitioners, researchers, the media, and the general public.

The National Center for Charitable Statistics (NCCS) became part of the Urban Institute in July 1996 and is the statistical arm of the CNP. The mission of NCCS is to build compatible national, state, and regional databases and to develop uniform standards for reporting on the activities of charitable organizations. NCCS databases are available on CD-ROM, diskette, 9-track tape, or via File Transfer Protocol (FTP) in a variety of database formats. For information, call (202) 828-1801 or visit our Web site (<http://www.urban.org/cnp>).

Series editor: Elizabeth T. Boris

Publisher: The Urban Institute, 2100 M Street, N.W., Washington, D.C. 20037
 Copyright © 1999

The views expressed are those of the author and do not necessarily reflect those of the Urban Institute, its board, its sponsors, or other authors in the series.

Permission is granted for reproduction of this document, with attribution to the Urban Institute.

For extra copies, call (202) 857-8687 or visit the Urban Institute's Web site (<http://www.urban.org>).

C. Eugene Steuerle is a senior fellow at the Urban Institute and author of a weekly column, "Economic Perspectives," for *Tax Notes* magazine. He is the coeditor with Elizabeth Boris of *Nonprofits and Government: Collaboration and Conflict* (Urban Institute Press, 1999) and has written 7 books, more than 125 reports and articles, and approximately 500 columns and 40 congressional testimonies or reports. His research on charity and philanthropy includes studies on the patterns of giving by the wealthy (for the Council on Foundations), the effect of taxes on charitable giving, payout rates for foundations (for the Filer Commission), unrelated business income taxes, and ways of simplifying and reforming tax rules for charitable contributions.