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Viewpoint

Are Donor-Advised Funds Good for Nonprofits

By Stanford Law School Policy Lab on Donor Advised Funds

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INSIGHTS FROM THE FRONT LINES

Are Donor-Advised Funds Good for Nonprofits?

Critics claim that DAFs unduly postpone funds needed by charities, but the vehicle offers many benefits that may outweigh its costs.

BY STANFORD LAW SCHOOL POLICY LAB ON DONOR ADVISED FUNDS

Donor-advised funds (DAFs) are an increasingly popular vehicle for charitable giving. There are now more than 500,000 individual DAFs across the United States, with assets upward of $100 billion. All DAFs are managed by "sponsors"—tax-exempt public charities that can administer any number of individual DAF accounts. Sponsors include community foundations, the charitable arms of investment managers such as Fidelity and Charles Schwab, religious organizations, and universities.

Donors (sometimes termed DAF "advisors" or "holders") receive a tax deduction when they contribute money or appreciated assets to a DAF. Donors can then request that the DAF sponsor distribute funds to the operating charities of their choosing. Although donors can only "advise," rather than require, a sponsor to make a gift, their advice is almost always heeded.

DAFs potentially affect both the timing of grants and the size of gifts: They often lead to delays in grants compared with gifts made directly to operating charities, but they probably lead to a larger total amount granted. It is especially the delay in grantmaking that has led to criticisms by nonprofits, which would prefer to have the gifts in hand as soon as possible.

POSTPONING GRANTS

Unlike foundations, which must distribute at least 5 percent of their endowments annually, DAFs have no payout requirements at all. However, the average payout for DAFs is about 20 percent—compared with foundations' average payout of slightly above 5 percent.

The CEOs of nonprofit organizations that deliver services to disadvantaged communities understandably want funds as soon as possible—on their watch. Yet the lives of their future beneficiaries are no less valuable than present ones. To be sure, a dollar spent now is—all else being equal—preferable to a dollar spent later, if only because the cumulative effect of inflation means that a dollar now will carry more purchasing power. But dollars in DAFs are invested in stocks, bonds, and other assets that tend to grow faster than the inflation rate. So the tradeoff posed by delay is not a dollar now versus a dollar later; in most times, it's a dollar now versus something more than a dollar later.

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

The first reason, *donor effectiveness*, is particularly relevant for donors who are new to philanthropy and have not yet determined what causes to support, let alone identified the most effective strategies for achieving their goals and organizations to fund. Consider a donor who sells a startup for millions of dollars and whose days continue to be occupied by her business. Without time to consider other causes, she might choose to give to a safe and familiar organization, such as her alma mater. The postponement of grantmaking offered by a DAF affords her the time to evaluate a broader range of causes. A more considered choice may allow the donor to derive greater personal fulfillment from her giving and, more important, may result in a decision that delivers greater social good.

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

Donors may also postpone giving for *legacy reasons*—for example to instill philanthropic values in their children or grandchildren by involving them in decisions and giving them discretion after the donor's death. Although creating a legacy is essentially personal, it may perpetuate practices of altruism that benefit society. Unless we have a compelling reason to believe a charitable dollar spent now

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This article is the product of the Stanford Law School Policy Lab practicum on donor-advised funds taught in the Winter Quarter 2019–20. The participants were Courtney Elise Cooperman, Drew Edwards, Alyssa Epstein, Alexandre Simoes Gomez Jr., Macey Lauren Olave, Fernando Rodriguez Silva Santisteban, Kavya Shankar, and Michelle Zhao. The course was cotaught by Stanford Law School professors Joseph Bankman and Paul Brest, and by Daniel Hemel, visiting professor from the University of Chicago Law School.

accomplishes significantly more good than a charitable dollar (plus appreciation) spent in the future, delay for legacy reasons can be positive on the whole.

Of course, some donors leave their DAF funds unspent as a matter of *inertia*, through procrastination or forgetfulness. Inertia is not categorically bad or good, however. Its social impact depends on whether it's more valuable to give now or later.

The net benefits of postponing grants depend not only on the nature of the problem that donors are tackling but also on how DAF funds are invested before they are granted. Generally, the assets contributed to DAFs are invested in mutual funds holding stocks, bonds, and other securities. Returns are likely to track market-wide returns on a risk-adjusted basis, and when returns are positive, they allow for larger ultimate grants. Some sponsors also offer opportunities to make "impact investments," such as low-interest loans to small businesses in underserved communities. When DAF dollars are invested in enterprises that themselves deliver social value, the good generated by those investments should be considered in the cost-benefit analysis of DAFs as well.

Any calculation of net benefits and costs must include the fees charged by DAF sponsors. There are two types of fees. Annual administrative fees, which cover the DAF sponsor's overall operating costs, are in the range of 0.6 percent of assets for an average-size DAF at the largest national sponsors. Investment fees, which are charged for managing invested assets in mutual funds or other vehicles, range from well below 0.1 percent of assets to above 1.0 percent. The percentages of both types of fees decline as DAF assets grow. Although larger amounts accumulated in funds allow sponsors to collect more in fees, we have not seen behaviors by major sponsors that discourage grantmaking. Donors' ability to transfer assets from a DAF at one institution to another acts as a competitive check on the fees that sponsors charge.

DAFS AND CHARITABLE GIVING

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

DAFs make it easier for donors to maximize the value of the charitable tax deduction in still other ways. A taxpayer who is facing the sale of a business or other liquidity event can get a tax deduction in the year of that event—when she is likely to be in a higher tax bracket—even before knowing which operating charity she would ultimately like to fund. Also, donors whose annual contributions fall below the level at which they benefit from itemized deductions may make one large donation to a DAF every several years, and so benefit from an itemized deduction in that year, but use a DAF to distribute funds more frequently.

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

Economic theory can help us estimate the impact of DAFs even when the data is indeterminate. Because DAFs make it more convenient to give and allow many donors to claim larger tax benefits, they reduce both the hassle of giving and donors' out-of-pocket costs for each dollar they contribute to an operating charity. They thus reduce the "after-tax price" of charitable giving. Generally, when the price of a good goes down, people buy more of it. Because DAFs reduce the after-tax price of giving, we would therefore expect the net effect of DAFs on overall donations to be positive.

Two other effects of DAFs are worth mentioning. First, some contributions to DAFs might have otherwise gone to private foundations, which have different legal rules, structure, and operations. One difference is that the average payout rate for DAFs is considerably greater than the required (and average) payout rate for private foundations. Thus, for contributions that would have otherwise gone to private foundations, DAFs may lead to an acceleration, rather than deferral, of payout. Moreover, while foundations often make restricted grants, most grants from DAFs are unrestricted—something highly valued by most organizations.

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

Our positive assessment does not rule out reforms targeted at specific holes in the DAF regulatory structure, such as the possibility of using DAFs to circumvent restrictions on organizations' eligibility for public charity status. We will leave to a later article this and other questions involving DAFs, including the valuation of complex assets, investment of assets in environmental, social, and governance (ESG) and impact funds, donor anonymity, and sponsor-imposed restrictions on allowable grantees. ■