A better way of giving

Easy to set up and accessible to a broader range of investors, donor-advised funds help clients achieve charitable goals and give advisers something to talk about

March 22, 2020

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Fortune 500 executive client of Dan Rinzema's had a lot of appreciated stock on his hands and felt charitably inclined. So Mr. Rinzema, chief client officer at Greenleaf Trust, turned to a donor-advised fund to help the client with both his tax and giving needs.

The increasingly popular vehicle allows investors to make contributions of cash or appreciated assets – such as public securities, private stock, real estate or art – that qualify for a charitable tax deduction. Once assets have been put in such a fund, investors can make grants to the charities of their choice.

Donor-advised funds facilitate large donations that exceed the higher standard deduction ushered in by the 2017 tax reform law and qualify investors for a tax deduction equal to the fair market value of the donation.

Using a donor-advised fund enabled Mr. Rinzema to "match a high-deduction year with a high-income year" and help the executive avoid capital gains taxes by gifting appreciated stocks, as opposed to cash. Just as importantly, the client can dole out charitable contributions from the DAF.

“They allow us to create impact in the community the way the client wants, while ensuring tax efficiencies,” Mr. Rinzema said.

The funds are touted as a way to strengthen client relationships because they allow financial advisers to start a conversation with clients about strategic charitable giving, even if the clients only make modest contributions.

Donor-advised funds have also generated some controversy because of their opacity. Donations can be made anonymously from the vehicles, and there’s no payout requirement or deadline.

One reason the popularity of DAFs has spiked in recent years are changes introduced by the 2017 tax reform law.

Under that measure, the standard deduction doubled to $12,400 for individuals and $24,800 for couples. The higher ceiling, combined with the elimination and reduction of many itemized deductions, has made it more difficult to earn a tax break for charitable giving.

A donor-advised fund often is used to combine several years’ worth of contributions into one donation that will qualify for a tax break in a particular year.

Katharine Earhart, co-founder of Fairlight Advisors, helped clients decide to bunch three years of donations into a $75,000 contribution to a donor-advised fund. It is housed at the East Bay Community Foundation, where the clients can help direct it toward charities in the San Francisco area.

While the clients are making distribution decisions on charitable donations, the fund is getting bigger.

“It’s sort of like a charitable piggy bank where assets can continue to grow tax-free,” said Ken Nopar, senior philanthropic adviser at the American Endowment Foundation, a large DAF.

The timeline from a charitable notion to a donation is fairly short when using DAFs, said David Bennett, president of the Community Foundation Research and Training Institute.

“Compared to a private foundation, it’s a lot easier to set them up and get them going,” Mr. Bennett said. “Most people can easily achieve their charitable goals through a DAF.”

Donor-advised funds also make charitable giving more accessible to those who do not have high net worth, Ms. Earhart said. “It’s a perfect strategy for the mass affluent and the affluent.”

Rapid growth

The widespread use of DAFs is evident in their rapid growth. Total contributions to DAFs grew by 20% in 2018 to $37.12 billion, according to the National Philanthropic Trust. Those donations represented 12.7% of all individual giving. A total of $23.42 billion was granted from DAFs in 2018, up from $19.7 billion in 2017. The total charitable assets in DAFs was $121.42 billion in 2018, up from $112.10 billion in 2017.

The NPF, which estimates there were about 728,563 donor-advised fund accounts in 2018, called them the most active and fastest-growing philanthropic vehicle.

“They’re absolutely taking off,” said Ann Gill, chief philanthropic officer at Vanguard Charitable.

Vanguard, Fidelity and Schwab sponsor donor-advised funds through their charitable organizations. Fidelity Charitable announced in February that donors recommended a record $7.3 billion in grants from their DAFs housed at Fidelity. Also in February, Vanguard Charitable said it had issued $10 billion in grants since its inception in 1997.

Ms. Gill touted the low cost, ease of use and flexibility of DAFs. But their value to financial advisers can also be measured in how they shape client relationships by catalyzing a discussion about what they want to do with their money.

“It takes the conversation to a deeper level,” Ms. Gill said. “You’re able to connect with them on an emotional basis. They’re not just talking about rebalancing their portfolio.”

Ms. Earhart encourages advisers to help their clients “prepare a philanthropic budget,” she said. “Ask them: What causes are you passionate about? It gives you another way to talk to your clients and get to know them."

Important outcome

Helping a client determine where to direct his or her charitable contributions is one of the most important outcomes of such conversations, said Peter Lipsett, vice president of DonorsTrust, a donor-advised fund. For instance, clients who are more conservative in their political views might want to contribute to Mr. Lipsett's fund, which he said does not give money to any organization that takes money from the government.

"The more financial advisers understand that there's this broad spectrum of providers for DAFs out there, the more their advice can go beyond tax savings to actually helping the client figure out the guidelines they have for their philanthropy," Mr. Lipsett said.

Critics of donor-advised funds say the vehicles are opaque, allowing those making contributions to hide behind a veil of anonymity, increasing the chances for self-dealing or contributions to radical organizations.

But advisers and other experts say anonymous donations are rare.

"I've worked with hundreds of DAFs; I've seen that one or two times," Mr. Bennett said.

Another criticism is that there are no rules governing when payouts must be made. Money can sit in DAFs for years without being granted.

'Insufficient data'

"There's insufficient data on a per account basis because the sponsoring organizations only have to file reports on an aggregate basis," said Ray Madoff, a professor and director of the Forum on Philanthropy and the Public Good at Boston College Law School.

Regulatory or legislative changes may be coming in this area. Recently, the California legislature considered a a bill that would require DAF payout rates.

Vanguard Charitable makes donors distribute at least $500 every three years. If they are inactive, the organization will grant 5% on their behalf.

“I would not be surprised if we see some kind of minimum payout requirement for DAFs,” Mr. Bennett said.

Unlike donations to a foundation, which produces a tax benefit on a cost basis, DAFs provide a tax break at the fair market value. This creates a problem when much of the giving to DAFs is in the form of appreciated assets, which can be complex, rather than cash, Ms. Madoff said.

“These assets are incredibly difficult to valuate accurately,” she said.

Regardless of how the assets are priced, when a client decides to put them in a DAF, they no longer belong to the client and often leave an advisory firm’s control.

“It’s not your money anymore,” said Richard Pon, owner of an eponymous CPA and advisory firm. “I have to keep reminding people of that.”

Managing the money

Many community foundations as well as the large brokerage DAF sponsors will let advisers continue to manage the money in a client’s DAF if it is large enough.

But advisers say they will recommend a DAF to a client if it’s the best way to facilitate – or launch – their charitable giving, even if it reduces their assets under management.

“That’s a great conversation to have with people,” said Gavin Morrissey, managing partner at FSA Wealth Management. “You’re not selling. This is precisely an advisory situation. If you’re chasing money over a DAF, you have to rethink the way you’re running your practice.”