Donor Advised Funds 101

Despite their shortcomings, DAFs are powerful tools.

Bruce DeBoskey | Sep 17, 2018

The fastest-growing tool in the philanthropic arena is the donor advised fund.

DAFs are the Internal Revenue Code Section 501(c)(3) philanthropic accounts established at a public charity. They allow donations of cash, property, appreciated assets and more—and donors receive immediate tax deductions. The DAF legally controls the money from the point of donation.

Subsequently, donors can advise regarding specific charities that should receive donations. Generally, the DAF follows the donor's advice. Plus, DAFs offer the option of completely anonymous donation.

Often, DAFs are associated with financial investment firms, such as Fidelity Charitable or Schwab Charitable, or with independent entities like the National Philanthropic Trust or the American Endowment Foundation. DAFs are also housed at more than 700 community foundations in cities across the country.

Today, there are about 300,000 DAFs in the United States, holding nearly $100 billion. In 2016, contributions were $23.27 billion. In that same year, donors recommended grants of $15.75 billion. From 2012 to 2016, giving to DAFs grew more than four times faster than individual giving as a whole—comprising 8.3 percent of all individual giving.

"Donor-advised funds are a tool for people who know they want to be philanthropic—even if they don't know how they want to do that yet," said Eileen Heisman, president and CEO of the National Philanthropic Trust. "Some donors know exactly where they want to give immediately, while others want to develop a giving strategy over time. DAFs give both types of philanthropists the resources and support needed to accomplish their giving goals."

Increased Scrutiny

Despite fast growth and unique advantages, DAFs have recently come under increasing scrutiny and criticism. Among the concerns are a lack of transparency and potential conflicts of interest for financial institutions that offer the funds while earning fees for their investment management. Here are a few other concerns:

With no payout requirements, donors receive immediate tax deductions, but funds can sit dormant for years. With charitable donations, a donor receives a significant tax deduction in return for the donated assets being deployed for the public good. That being said, most DAFs report that from 16 to 20 percent of donated assets go out to charity each year. This is much higher than the 5 percent required payout for private foundations.

There's no requirement that DAF money be paid out to charities at any time. The major DAFs report that from 80 percent to 84 percent of their assets are paid out to charities over a 10-year period, leaving 16 percent to 20 percent of their contributions sitting dormant. However, study found that nearly 22 percent of DAF sponsors in 2012 made zero distributions.

The "no payout" problem would be best-addressed by sponsors identifying dormant DAFs and requiring donors to direct donations to charities or forfeit existing tax deductions. A DAF could be deemed "dormant" if no significant charitable donations have been made in the prior 24 months. Alternatively, DAFs could require that all funds must be paid out to charity within a certain time period.

Private foundations can satisfy their payout requirements by donating to a DAF. As mentioned above, PFs are required to distribute roughly 5 percent of their assets each year to public charities. Some PFs satisfy this requirement by distributing some (or all) of this amount to a DAF. If these funds sit dormant, as they currently are, no public good is being served. Creating new dormant account rules would eliminate this problem while preserving the DAF option for PFs.

Many donations to DAFs are of appreciated private assets, which are difficult to value. A donation of appreciated privately held assets to a DAF creates an immediate tax deduction for the donor, even though the DAF may receive amounts less than the appraised value when those assets are liquidated. This disrupts the essential balance between deduction and contribution to the public good. One way

to address this problem would be to tie the tax deductability of the donation to the actual amount ultimately received by the DAF.

DAFs are powerful tools for donors and charities to accomplish important social good. Their advantages far outweigh their shortcomings. However, there's room for improvement—through self-regulation or through Internal Revenue Service or Congressional intervention. Such sharpening could make a good tool even better.

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