Cumberland Advisors Market Commentary – Time to Re-Examine Donor-Advised Fund Tax Policy

The tax treatment and rules governing donor-advised funds (DAFs) continue to garner attention nationwide. According to the National Philanthropic Trust's *2018 DAF Report*, as of FY 2017 over $110 billion was housed within 463,622 DAFs across 604 community foundations, 345 single-issue charities, and 53 national charities. Donors contributed $17.24 billion in 2013, which rose to $29.23 billion in 2017. From 2012 to 2016, the compound annual growth rate of contributions to DAFs was 15.7%.

What is a DAF, anyway? And how does it work?

A DAF is a charitable vehicle housed within a public charity, to which an individual (or corporate donor) contributes a gift of cash, appreciated securities, or even shares in a privately held business. Once the value of the gift is established, the donor realizes an immediate tax benefit. A deduction of up to 60% of adjusted gross income (AGI) applies to gifts of cash. A double tax benefit accrues to an individual contributing appreciated assets to a DAF. Once the theoretically low-cost-basis asset is transferred into the DAF and liquidated, capital gains liabilities are avoided, and a deduction of up to 30% of AGI can be realized.

Over time, the donor directs the public charity to make grants from the fund to individual nonprofits. Some donors may quickly distribute funds from their DAF, drawing it down to zero over 2–3 years. Other DAFs are permanently endowed; the principal is invested with an eye toward sustaining disbursements in perpetuity. A spending policy dictates annual grant making. Many DAF sponsors, whether they are the charitable arm of a financial services institution or a local community foundation, require a minimum annual distribution from each DAF to an operating charity.

But, technically, the law does not mandate that DAFs follow any standardized payout schedule. Unlike private foundations, which must pay out roughly 5% of their assets each year, DAFs are not bound by an annual distribution requirement.

Some legal scholars view the absence of mandatory distributions as a loophole that must be closed.

In a 2017 letter to the United States Senate Committee on Finance, Professors Ray Madoff of Boston College Law School and Roger Colinvaux of The Catholic University of America, wrote that "While some DAF sponsors have high overall distribution rates, according to the IRS, a full 25 percent of DAF sponsors distributed less than one percent of their assets in a year." A consortium of organizations that lobby on behalf of the charitable sector challenged that statistic, claiming that the accounts referenced by Madoff and Colinvaux "… represent a very small fraction of DAF accounts or DAF assets."

Madoff and Colinvaux's concerns stem from what they believe to be flawed tax policy governing DAFs.

Whereas the DAF donor gains an immediate and oftentimes significant tax benefit commensurate with the dollar value of the contribution, it could be years before monies are disbursed to an operating charity. In essence, the publicly financed tax deduction that accrues to the donor may not be "recouped" by the public for years, until funds from the DAF are sent to a homeless shelter, educational institution, or hurricane relief effort.

To combat dormant DAFs, Madoff and Colinvaux proposed a 10-year payout timetable to accelerate the distribution of DAF dollars. In a 2018 opinion editorial published in the *Nonprofit Quarterly*, Madoff also suggested that policymakers may consider tweaking the tax code and "… tying some of the charitable benefits to the release of DAF funds. For example, Congress could enact rules that would allow donors to avoid capital gains on transfers of property into DAFs, but would delay the charitable deduction until such time as funds are distributed from the DAF to non-DAF beneficiaries."

Temporally aligning the tax benefit with the realization of public benefit makes some sense to us.

However, we will build on Madoff and Colinvaux's ideas and propose an alternative method to incentivize donors to balance the charitable needs of the present *and* the future: (1) maintain the capital gains shelter afforded to donors who elect to contribute appreciated assets, and (2) award a tax benefit only when grants from the DAFs are made to "working charities"; but here's the kicker: (3) continue to award a tax benefit to the donor as grants are made, even if the total tax benefit is in excess of the initial gift. That way, those DAFs designed as multigenerational giving vehicles can be rewarded for prudent, long-term investing and giving.
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Buffett's 2018 Letter / Fees Matter When Investing "Forever" / Clear Your Calendar for April 11th

In the Oracle of Omaha's 54th annual letter to Berkshire Hathaway shareholders, Warren Buffett celebrates the dynamism of the American economy while cautioning investors against high-cost advisory fee arrangements.

Buffett attributes the success of the United States to *the American tailwind* – a force animated by patriotism, sacrifice, and the belief that "generations beyond would live far better lives than they themselves had led."[1] The discipline of prior generations who spent less than they earned, investing their hard-earned savings, drove productivity gains and raised living standards. Just like America's, Berkshire's geometric growth, Buffett says, can be attributed to the accumulation and reinvestment of the holding company's "savings," or as corporate managers would call them, retained earnings.

Here's Buffett:

“In 1788 – to go back to our starting point – there really wasn’t much here *except* for a small band of ambitious people and an embryonic governing framework aimed at turning their dreams into reality. Today, the Federal Reserve estimates our household wealth at $108 *trillion*, an amount almost impossible to comprehend.

“Remember, earlier in this letter, how I described retained earnings as having been the key to Berkshire’s prosperity? So it has been with America. In the nation’s accounting, the comparable item is labeled ‘savings.’ And save we have. If our forefathers had instead consumed all they produced, there would have been no investment, no productivity gains and no leap in living standards.”

Buffett recalls how on March 11, 1942, at age 11, with battlefronts opened wide in the European and Pacific theaters, he traded his “life savings” of $114.75 for three shares of Cities Service preferred stock. How much would the $114.75 be worth today, if the proceeds generated from young Buffett’s lawn-mowing/snow-shoveling/golf ball-collecting and resale operation had been placed in a no-cost index fund tracking the S&P 500, with dividends reinvested?

Answer:

“If my $114.75 had been invested in a no-fee S&P 500 index fund, and all dividends had been reinvested, my stake would have grown to be worth (pre-taxes) $606,811 on January 31, 2019 (the latest data available before the printing of this letter). That is a gain of *5,288 for 1.* Meanwhile, a $1 million investment by a tax-free institution of that time – say, a pension fund or college endowment – would have grown to about $5.3 *billion*.

“Let me add one additional calculation that I believe will shock you: If that hypothetical institution had paid only 1% of assets annually to various ‘helpers,’ such as investment managers and consultants, its gain would have been cut in half, to $2.65 billion. That's what happens over 77 years when the 11.8% annual return actually achieved by the S&P 500 is recalculated at a 10.8% rate."

These figures are a wake-up call for investment committees overseeing perpetual funds of nonprofit institutions, small and large. The Sarasota-Manatee region is home to three community foundations, a half dozen private foundations, several higher education institutions and dozens of independent nonprofits with endowed funds. We will exclude the few hundred million sitting in the reserve accounts of local municipalities, as state statute restricts investment options to short-term, high-grade, fixed-income instruments. By our calculations, in the two-county area there is well over $1 billion in charitable dollars invested in some form of traditional endowment model, an investment approach that tends to lean heavily on "exotic," generally illiquid alternatives (hedge funds, private equity, and real assets), with the balance invested in more familiar global marketable equity and debt securities. Frequently this investment mix is developed and overseen by a consultant, who selects and monitors a stable of underlying managers. Two layers of fees – consultant and manager – are now added to brokerage and custody costs. Now, if this "outsourced chief investment officer" (OCIO) model were "working," the alpha generated from the underlying managers and the skill of the OCIO in setting asset class exposure targets and selecting top-performing managers would, over time, surmount the added fee layers and produce returns that, at minimum, meet a benchmark.

However, a recent study authored by Professors Sandeep Dahiya of Georgetown University's McDonough School of Business and David Yermack of New York University's Stern School of Business analyzed the returns of 28,296 nonprofit endowments from 2009–2016. They found the median return for the 8-year period across 28,000+ organizations to be 3.75%, while a 60%

domestic equity/40% Treasury bond construction delivered 9.28%.[2] After a decade of lagging results nationwide, it is time for a sea change in how monies designated for perpetual charitable support are invested.

With $1 billion in philanthropic dollars managed in a framework similar to that of the thousands of endowments surveyed by Dahiya and Yermack, we are giving up $50 million of local charitable support annually. Over 20,000 children in Sarasota County schools rely on a free or reduced lunch.[3] That is 20,000 families who need every potential charitable dollar brought to bear on summer nutrition programs, help with housing, basic medical care, and job training.

On April 11th, we will elevate this conversation around health, hunger, and philanthropy. National and local authorities are convening for our third annual Financial Literacy Day at the USF Sarasota-Manatee campus. Dr. Judith Monroe, President and CEO of the Center for Disease Control Foundation; Lisa Marsh Ryerson, President of the AARP Foundation; and Erin McLeod, President and CEO of the Friendship Centers, will lead a panel discussion. A dozen other nationally recognized speakers will discuss topics related to global financial markets, the trade war, and Federal Reserve policy. Please call 800-257-7013 or visit http://sar.usfsm.edu/event/financial-markets-and-the-economy/ to confirm your attendance and participation. Cost is just $50 to cover a light breakfast and catered lunch.

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[1] http://www.berkshirehathaway.com/letters/letters.html
[2]

https://papers.ssrn.com/sol3/Papers.cfm?abstract_id=3291117
[3] https://www.heraldtribune.com/news/20181019/lunch-means-more-for-some-in-sarasota-county-schools

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