PG Calc — YOUR PARTNER IN PLANNED GIVING SUCCESS

"Please, Sir, I Want Some More"
The Plight of Orphan DAFs

PG Calc Featured Article, June 2023 *eRate*

By Craig Wruck, PG Calc Senior Advisor

What happens when there is money left in a donor-advised fund after the last donor-advisor has died? Where does that money go? Who decides how the money is used? Like a street urchin in a Charles Dickens novel, an "orphan donor-advised fund" can sometimes achieve great expectations or, sadly, pass invisibly without much impact. And, like Dickens' obsession with orphans, there are those who are concerned about the growing orphan population and some who would exploit these orphans for their own purposes.

The Shibboleth of DAF Distributions

There has been growing – and largely fallacious – concern that donors are taking advantage of donor-advised funds to claim an income tax charitable deduction with little urgency about using the money for charitable purposes. Two issues are often raised: donors receive an income tax deduction in the year of the contribution, even though the funds are not put to charitable use until sometime in the future, and donor-advised fund sponsors benefit from accumulating and managing donor-advised fund assets.

Senators Charles Grassley (R-IA) and Angus King (I-ME) have proposed legislation to curtail these perceived abuses by requiring distributions within a 15-year period or denying the charitable deduction until the money is distributed to the ultimate charitable recipient. Senator King said, "The idea of getting a tax deduction today for money that may not be paid out for 50 years makes no sense," adding, "I understand you might want to put it into a fund and have someone else manage it. But it's got to go out within a reasonable period of time. Otherwise, it's an abuse of the tax code."

While concern about the elapsed time between the charitable deduction and the eventual use of the money for charitable purposes is legitimate, the fact is contributions to donor-advised funds are usually distributed relatively soon after the deductible contribution is made. According to the National Philanthropic Trust, 27% of dollars contributed are distributed in the year in which they are contributed, and, on average, donor-advised funds distribute 22% of their assets each year. (Interestingly, National Philanthropic Trust indicates that national donor-advised funds distribute nearly half again as much, 31%, compared to 21% from traditional community foundations.)

How DAFs Become Orphaned

Before considering the fate of orphaned donor-advised funds, it is helpful to understand an essential but often overlooked fact about donor advised funds: when a donor contributes to a donor-advised fund, she is making an unrestricted charitable contribution to the sponsoring charity. The only right retained by the donor is the privilege of offering non-binding recommendations regarding how the money will be used.

Of course, in practice the sponsoring charity virtually always follows the donor-advisor's recommendations. If the donor-advised fund sponsor routinely ignored the donor-advisor's recommendations, donors would soon stop making contributions to their donor-advised funds. However, make no mistake: the sponsoring charity is unilaterally empowered to – and exclusively responsible for – selecting the charitable organizations that receive distributions from its donor-advised funds and for determining the amount and timing of those distributions.

Obviously, after the end of her lifetime, the donor-advisor can no longer offer advice on how funds are distributed. Anything remaining in her donor-advised fund becomes an "orphaned donor-advised fund." These orphaned donor-advised funds are unrestricted assets of the sponsoring charity, and the sponsoring charity is obliged to ensure that they are put to good use in pursuit of charitable purposes – any charitable purposes the sponsoring charity chooses. The ultimate disposition of orphaned donor-advised funds depends upon policies and guidelines established by the sponsoring charity.

Because there is no formal definition of an orphaned donor-advised fund, it is difficult to tell exactly how often donor-advised funds become orphaned and how much money is left in orphaned funds. According to the Donor-Advised Fund Research Collaborative, almost all donor-advised fund sponsors (83-95%) have policies regulating inactive accounts. The Collaborative reports that the average donor-advised fund sponsoring charity considers a donor-advised fund account to be inactive if no grants have been made for at least 36 months, after which the sponsoring charity makes efforts to contact the donor-advisor and allows another 18 months before making its own distributions.

The Fate of Orphaned DAFs

A key consideration in the ultimate use of orphaned donor-advised funds is the nature of the sponsoring charity. Traditional community foundations often have well established grantmaking programs and are versed in the needs and trends in their communities. For a traditional community foundation, orphaned donor-advised funds are a source of unrestricted funds that can be put to good use immediately. The national donor-advised fund programs affiliated with financial services firms face a different set of challenges when determining how to dispose of orphaned donor-advised funds.

To address this, many national donor-advised fund programs have adopted grantmaking approaches like the "Fidelity Charitable Trustee's Initiative," a program that makes distributions from orphaned donor-advised funds at the Fidelity Charitable Gift Fund. Fidelity does not report the number or total value of orphaned funds, but for 2022 the Fidelity Trustee's Initiative made a total of $9 million in grants. Although this is a significant amount, especially to the recipient charities, it is less than 0.1% of the $11.8 billion distributed by the Fidelity Charitable Gift Fund overall. (To provide a sense of scale: the Fidelity Charitable Gift Fund received $15 billion in new contributions that year and reported expenses of $191 million, including $124 million in administrative fees and $45 million in investment management fees.)

The Adoption Alternative
Are orphaned donor-advised funds destined to be abandoned to the sponsoring charity? Are there alternative succession plans? The answer depends upon the policies and procedures of the sponsoring charity. At Vanguard Charitable, donor-advisors are afforded a range of choices and can select from among five options for final distributions from their donor-advised fund:

> **Option 1:** Name up to two successor-advisors.
>
> **Option 2:** Direct that one or more new donor-advised funds are to be created, each with up with up to two successor-advisors.
>
> **Option 3:** Provide a standing recommendation for final grants to one or more charitable organizations.
>
> **Option 4:** Establish a program of recurring grants, essentially creating a permanent or quasi-endowed fund.
>
> **Option 5:** Transfer the donor-advised fund assets to a "field of interest fund" from which the sponsoring charity can make grants within broad categories.

Tapping Orphaned DAFs for Your Charity
Many donor-advised fund sponsors offer a choice similar to Vanguard's Option 3 above, usually by allowing the donor-advisor to designate one or more charitable organizations as successor advisor with the intention that the remaining funds be distributed to the charitable organization. This is not the same as a beneficiary designation for IRA or other financial account. The donor-advisor appoints a charity (or charities) as the successor

advisor with a standing recommendation to distribute the funds to the charitable organization. The specifics vary among donor-advised fund sponsors. The donor-advisor should contact the donor-advised fund sponsor for guidance.

Donor-advised fund donors are usually sophisticated about their philanthropy. They create donor-advised funds as a way to organize and manage their charitable giving. It is worthwhile to have conversations with these donors about the ultimate fate of their donor-advised funds. Have they considered what will happen to their donor-advised fund after they are gone? Does their donor-advised fund sponsor offer alternatives? Might they consider a succession plan including your organization?

Like those Dickens characters, orphans face many challenges but, with a little help, can go on to great expectations.

Historical Aside

Ironically, orphaned charitable funds were the catalyst that led to the invention of community foundations. The Cleveland Foundation, regarded as the first modern community foundation, was founded more than a century ago by commercial trust companies that were accumulating assets in various "charitable trusts" intended to be used for charitable purposes in the city. As donors and their heirs died, it fell to trust officers to select the charitable recipients of these orphaned funds. For half a century, most community foundations were organized around this "community trust" model – collections of legacy charitable trust accounts overseen and managed for the benefit of the community.

With the Tax Act of 1969, community foundations were confronted with a new hurdle: the public support test. The 1969 law sharpened the distinction between private foundations and public charities. Although there are categorical public charities – e.g., educational institutions – community foundations must meet a "public support test" to maintain their status as public charities. The public support test requires community foundations to secure at least one-third of their annual income – including investment income – in the form of new contributions from donors. The innovation of donor-advised funds was, in part, a tool to help community foundations meet their annual public support test.

Resources

National Philanthropic Trust Donor-Advised Fund Report

Donor-Advised Fund Research Collaborative

Fidelity Charitable Trustees' Initiative

Critics Take Aim at Charitable Money Sitting in Donor Funds (Associated Press)

Cleveland Foundation Website