Timing of Deduction and Payout Rates

DREW EDWARDS: My name is Drew Edwards. I’m in my first year at the law school and I worked with Alex Gomez on the timing of the tax deduction and payout rates.

When a DAF holder contributes to her account, she receives an immediate tax deduction. These funds are reserved for charitable use, but there’s no requirement that a certain percentage be paid out on an annual basis. Some critics are concerned that because assets could theoretically remain in a DAF forever, they might never make their way to an operating charity. We found that, on average, DAFs distribute approximately 20% of their assets per year. As a point of comparison, the minimum required pay out for private foundations is 5%. That said, there is variation in pay out rates among individual DAFs ranging from 100% on the high end to 0% on the low end.

So why might a DAF holder choose to delay payout? There are several rationales, some of which we would view as more beneficial to society than others.

First, there’s what we call donor effectiveness. Some donors need time to become effective givers. Imagine a donor who recently received a considerable amount of money, perhaps from an inheritance or through the sale of a startup. This donor may need time to determine what causes she cares about and select effective organizations in those areas.

Next there’s what we call cause effectiveness. A donor’s chosen cause may require funding at a later date. For instance, we know that emergency funding related to COVID-19 will not be around forever. A donor may recognize this and choose to support long-term projects that provide health and welfare services to underserved communities that will still be underserved once the emergency funds have been depleted. As a second example, consider climate change mitigation initiatives. We have some technologies such as solar panels and electric vehicles that have begun to address the issue, but the technological landscape is undergoing rapid development. A donor may see this and choose to delay giving, expecting that technological advancement will make his contribution more effective later on.

A DAF holder may also desire to build a legacy of giving. He may wish to have gifts made in his name even after his death or include his children in his philanthropy. The desire is to leave a legacy and pass on philanthropic values are beneficial to society, to the extent that they motivate additional giving.
Finally, there’s an inertia. Some DAF holders may delay pay outs simply because they’re procrastinating or have forgotten about their accounts. Of all the rationales for delay, we would probably view this as the most problematic.

I’ll now turn it over to Alex who will discuss additional considerations related to timing and some existing proposals.

ALEX GOMEZ: Thank you, Drew. I’m Alex. I’ve been working with Drew on the timing project, and I’m a Master’s Student in management science and engineering. So I’d like to talk about, first, about some additional considerations that are also related to timing and make this topic even more complex and important in the context of DAFs.

So the first thing is we know that the funds stored in DAFs, they will either be invested and generate some financial return, or they will be granted to a non-profit, and there will be a return to society associated with this. And it would be ideal if you could compare as a donor, these two rates of return in order to make the best decision because it could be the case, for example, that instead of making the grant immediately, a donor decides to keep the assets in the DAF, increase their values, and then make a larger grant in the future. And it could be the case that society would benefit better from this future grant, or the opposite could be true as well, society would benefit better from an immediate grant, even if the amount is smaller than it could be in the future. It’s important to keep in mind that both of these scenarios are possible.

It’s actually even possible that society would benefit from the assets stored in DAFs even before the grants are made through options such as social investing that are offered by some DAFs.

And just the third point to keep in mind is that the funds in DAFs, they can be a good option to keep donations flowing to the non-profit sector, even in times of economic hardship, because the donors, they do not own these funds anymore once they are transferred to DAFs, and, therefore, they do not depend economically on them. So even if a donor is going through a time of economic hardship, they would probably not let this affect their decision of recommending the grants.

So considering all of these aspects that me and Drew talked about, there are still definitely some concerns associated with timing, and to address them, there are some existing proposals.
The first of them that is worth mentioning is the one proposed by Colinvaux… Roger Colinvaux and Ray Madoff, in which they suggest that we should postpone the time of the tax deduction until the moment when the grant is actually made to a non-profit, instead of giving the benefits to the donors right when they transfer their assets to a DAF. So this would definitely put some pressure onto the donors for them to donate, to recommend, the grants faster.

However, there are also some critiques to these proposals, such as the ones made by one of our professors, Daniel Hemel, one of the critiques is that these could increase the costs or reduce the benefits for donors of using DAFs. For example, a donor should try to use the tax discount in the years of their lives when they have the highest income in order to maximize the benefits. And not coincidentally, usually these times are the moments in life when the donors are also the busiest because they are working more. So if a donor wants to use the tax discount under this new proposal, they will not only have to transfer their assets to a DAF, they would also have to choose which organizations would receive the grant. And these can be seen as an increased cost, operational cost, to using DAFs, or if a donor could not do that, they will not be able to use the tax discount in the moments of their lives when they would most benefit from it, and, therefore, they would have a reduced benefit. And it can be the case that these two aspects will lead to a decrease in the total amount of donations, or they could also lead to poor decisions made by the donors when recommending the grants. A more detailed discussion of this proposal, and also the critiques, can be found in two articles in the Chronicle of Philanthropy.

And moving on, a second existing proposal that is already being implemented by some DAF sponsors is to nudge donors and check with them on a regular basis to guarantee that they are recommending grants, and, therefore, avoid lack of grants due to inertia. And this is an initiative that can come from their own DAF sponsors.

And, third, another proposal would be to actually impose a strict regulation requiring a minimum payout for each DAF account. And in this way, we would be able to guarantee that all DAF accounts are making grants on a regular basis.

And just a last point to keep in mind, while all of these proposals, they might be effective in dealing with the timing problem, they might also be contradictory to the idea of cause effectiveness and donor effectiveness, meaning that not necessarily they would lead to the optimal timing of donations.