ACCELERATING CHARITABLE EFFORTS (ACE) ACT

SUMMARY AND KEY CONTEXT

Background

Charitable organizations hold a privileged position in U.S. law. The tax code exempts nonprofits and their donors from some financial obligations under the assumption that the resources that otherwise would have flowed into the Department of Treasury are invested directly into communities. In the 1960s, U.S. policymakers expressed concern donors were reaping the tax benefits from philanthropy, but the funds were not necessarily benefitting communities. Specifically, policymakers expressed concerns about wealthy donors' abuse or self-dealing through philanthropic vehicles. The Tax Reform Act of 1969 (TRA69) passed sweeping reforms, including the first legal definition of a private foundation, which stipulated that they do not receive substantial support from a wide array of public sources (i.e. "the public support test"). The bill also included a requirement for them to pay at least 5 percent of their assets each year.

In the 50 years since TRA69, the landscape and best practices within philanthropy shifted. Although the first donor advised funds (DAFs) were established in the 1930s, they did not begin to take off until the 1990s. By 2000, the President's Budget called for the regulation of DAFs. Since that time, the sector observed the exponential growth of DAFs as convenient, streamlined vehicles for individual donors and philanthropic institutions to strategically invest in communities. One example of DAFs' growing influence on charitable giving is the fact that today's top 10 largest charities, in terms of dollars raised, include several DAF sponsoring organizations that were not present on the list a decade ago.

This year is the 15th anniversary of the Pension Protection Act, the last major charitable reform bill that clarified current laws governing philanthropy and DAFs. The question debated within the sector and among policymakers is whether these essential giving tools can be improved through more regulation.

Relevance to Sector

The most tangible application of this debate to individual nonprofits is the question of whether more regulation of philanthropy will result in more resources flowing to advance charitable missions. It would be helpful to have data to help clarify the extent to which policies will impact the flow of money already donated to philanthropic institutions, or whether they also will impact future donations. It also would be important to understand the extent time-bound spend-out rates may influence where and how resources flow into communities.

From a sector-wide perspective, it is important to regularly question the extent best practices, enforcement of current law, or new laws are needed to protect the public's trust in philanthropy and the broader sector. Independent Sector's 2020 study on the public's trust in nonprofits and philanthropy found Americans trusted philanthropy significantly less than public charities. The least trusted were high-net worth donors, which had a net trust score of eight. If the sector seeks to strengthen public trust in philanthropy and the broader sector, do oversight officials need support enforcing current law or is policy change necessary? If policy change is needed, nonprofit leaders and policymakers would benefit from an analysis of how underlying strategic drivers of public trust align with policy proposals to strengthen oversight.

Bill Summary

On June 9, 2021, Senators King (ME) and Grassley (IA) introduced the Accelerate Charitable Efforts ("ACE") Act, which revises current laws dictating the pace and transparency of resources flowing from private foundations and donor advised funds. Proponents of the bill argue that the policies in the bill increase transparency necessary to build public trust and improve the timely flow of existing resources to working charities. Opponents argue that philanthropic resources already flow to working charities at rates higher than those proposed in the bill, and changes may negatively impact the administrative flexibility needed to invest thoughtfully in communities.

ACE Act Summary & Questions

Donor Advised Funds

ACE Act Legislative Provisions

The ACE Act creates three categories of donor advised funds (DAFs):

1. "Qualified DAF" – A DAF with an establishing agreement that stipulates any contribution must be distributed within 15 years or the account holder loses advisory privileges. Account holders must identify a preferred organization to receive contributions that fail to meet this 15-year requirement.
2. "Qualified Community Foundation DAF" – A DAF that is sponsored by a "Qualified Community Foundation" and for which either:
    - The account holder has advisory privileges over no more than $1 million total throughout the sponsoring organization, or
    - The establishing agreement requires the account to distribute at least 5 percent of its value annually.

   The definition of a qualified community foundation requires the organization to be geographically focused on four or fewer states and hold at least 25 percent of its assets outside of DAFs.
3. "Nonqualified DAF" – An account that does not meet the requirements above.

ACE Act restrictions on deductions for contributions to DAFs

- For contributions to nonqualified DAFs, there is no deduction until:
    - Any donated property is sold by the sponsoring organization,
    - Cash contributions or proceeds from the sale of donated property are distributed to charities, and
    - The amount of the deduction matches that of the distribution.
- For contributions of non-publicly traded assets to a qualified DAF or qualified community foundation DAF, no charitable deduction is allowed until the sponsoring organization sells the asset and the deduction shall not exceed the gross proceeds from the sale of the asset.
- There is no deduction allowed for the contributions described above unless a taxpayer receives a contemporaneous written acknowledgement of the sale or distribution amount.
- Undistributed contributions are subject to a 50% excise tax:
    - In year 15, for qualified DAFs, and
    - In year 50, for nonqualified DAFs.

DAF Context & Questions

Donor-advised funds (DAFs) are managed by public charities and DAF-sponsor organizations now are some of the largest charities in America. Donor-advised funds are not subject to a payout rate like foundations. DAF proponents say they help democratize philanthropy by allowing mid-sized donors to grow their moderate donations into legacies that rival the influence of major donors. However, current oversight rules do not address major points of contention within the sector:

- *Timing Mismatch* – The income tax deduction for charitable contributions is a federal subsidy intended to finance the production of charitable goods and services. Reform advocates say that philanthropic institutions, like private foundations and DAFs, do not directly produce charitable goods and services (i.e., they are not "working charities"), and that the federal tax "subsidy" should not apply as robustly to gifts to such institutions. A particular challenge with the timing mismatch is a concern that the value of charitable assets may change between the time donors claim the deduction and the time the assets are converted into investments in community good. The bill proposes changes in tax policy to match the timing of the production of charitable goods and services with the timing of the charitable deduction. Specifically, they recommend deferring the income tax charitable contribution deduction for gifts to such philanthropic institutions until the gift is used by a "working charity" to produce goods and services.
- *Short- vs. Long-term Investments* - The most frequent debate around philanthropic payout is about the fundamental value of private foundations, DAFs, and charitable endowments. Should all available charitable resources be spent on a short timeline in an attempt to meet overwhelming need, or does it make sense to invest resources and grow resources to invest over a longer time horizon to support intractable social problems or future needs? Advocates for increasing philanthropic payout rates assert that times of economic crisis call for prioritizing short-term, immediate needs over long-term priorities. One proposal to accomplish this goal is to incentivize the timely distribution of philanthropic resources to fund work in charities today, rather than investing in endowments, DAFs, or foundations to generate a larger pool of resources in the future.

Opponents of mandated DAF payout requirements assert that they are solutions in search of a problem since average aggregate DAF sponsors payout at rates well above 7-10%. A recent letter to the Hill notes that during COVID, DAF sponsors saw both the value and number of grants increase by 50 percent. On the other hand, DAFs are not legally required to payout at all. When disaggregated by individual accounts, payout rates vary from zero to over 20 percent, and they can include payments from one DAF to another.

Discussions of DAF regulation typically include concerns about the well-being of community foundations that manage DAFs. This bill carves out rules tailored for community foundations because they have an incentive to prioritize community interests over donors. It is important to note that other types of charities that sponsor DAFs also prioritize community needs and even provide direct services. The bill's community foundation definition also does not include issue-based community foundations that focus on issues ranging from religion to LGBTQ rights.

Many charitable giving researchers conclude that tax policies that are easier for donors to understand tend to be more effective in incentivizing donations. It will be important to understand the extent charitable giving tax incentives remain salient to mid-sized donors across all levels of the new regulatory structure outlined in the bill.

ACE Act DAF provisions introduce a range of payout timelines ranging from 15 to 50 years. Lessons from research on strategic philanthropy found that short versus long-term accountability timelines for grantees often yield different results. If time horizons are a necessary feature of increased DAF oversight, it is critical to understand whether different payout timelines outlined in this bill may impact which organizations or activities are funded by DAFs.

The bill prohibits donors' ability to claim a charitable deduction for gifts of assets, depending on the type of asset and whether the DAF is qualified. Specifically, limitations of non-publicly traded assets address concerns about donors claiming a much higher deduction for the donation of an asset than what it produced in real dollars for charity. News stories accused billionaires of using DAFs to avoid taxes and shortchanging communities. Although these cases are few when compared to all the well-intentioned, community-minded gifts flowing through DAFs, it is possible high-profile stories like these contribute to the low levels of public trust in high net worth donors. Presumably, this provision will incentivize donors and DAF sponsors to quickly sell donated assets and distribute the proceeds to charity, so the donor can claim a charitable deduction. However, it would be helpful to better understand the extent to which there are circumstances in which waiting to sell a donated asset is beneficial to grantees.

Questions

1. To what extent are current practices and voluntarily payouts sufficient to promote public trust? Is a mandated floor necessary?
2. If more regulation of DAF accounts is needed, should all DAF sponsors be treated equally, or should different rules apply based on characteristics of the sponsoring organizations?
3. To what extent does the ACE Act definition of qualified community foundations accurately describe the target organizations? Should the definition be expanded to include other community-focused DAF sponsors?
4. How may the multi-faceted regulatory policies in this bill influence the behavior of mid-sized donors, who are less likely than major donors to use tax advisors?
5. To what extent may new payout rules and timelines impact not just the types organizations funded, but the types of activities they pursue with those funds? What research can inform the downstream equitable impact of the bill on communities?
6. How may incentives to quickly sell donated assets impact total resources flowing to charities?
7. How may the oversight and regulation of DAFs held by public charities influence future rules governing charitable endowments or private foundations, particularly if policymakers draw similarities between two philanthropic vehicles?

Private Foundations

ACE Act Legislative Provisions

- For the purposes of calculating compliance with the private foundation annual payout requirement of 5%, certain expenses are disallowed:
    a. Administrative expenses paid to a "disqualified person," including certain family members and significant contributors, and
    b. Distributions made to DAFs.

- For the purposes of calculating private foundation excise tax obligations, no excise tax is owed if:
    - The foundation pays out 7% or more of its value in an any given year, or
    - The foundation's governing documents specify a duration for the foundation of not more than 25 years.
- Private foundations are required to include information about distributions to DAFs on their annual form 990, including the amount, the name of the sponsoring organization, and any donation advice that was included.

Private Foundation Context & Questions

Private foundations can currently include administrative expenses when calculating their 5 percent payout. The law would prevent counting salaries paid to a substantial foundation contributor or family member as a part of the distribution requirement. A study of the 10,000 largest foundations found 18 percent compensate board members or institutional trustees. Foundations staffed by families tend to report lower overall administrative costs, but more professional, paid staff are correlated with higher voluntary payout rates. Supporters of the provision assert that it preserves the purpose of the payout rate, which is to ensure foundation assets are invested in communities. Opponents assert this provision undervalues the contributions of working family members.

The bill also disallows private foundation contributions to DAFs as counting toward annual foundation payout requirements. Again, supporters believe this provision upholds policymakers' intent when they established private foundation payout requirements in 1969. Some private foundations cite DAFs as useful tools to complement their grantmaking strategies, such as the ability to combine funds with other foundations to support a joint initiative. It would be helpful to access a complete list of ways in which private foundations utilize DAFs as a part of their distribution requirement to increase sector and policymaker understanding of the relationship between the two institutions, but also brainstorm whether alternatives to DAFs could accomplish similar goals.

The ACE Act incentivizes private foundations to pay out 7 percent or more each year in trade for exemption from the private foundation excise tax. Several foundation leaders appreciate the provision offering a "carrot" to increase payout rates rather than a "stick." Research suggests regular payouts over 7 percent may reduce the total amount of resources available to charities. To maintain their spending power over the course of many years, private foundations need to earn a return on their investments that is at least equal to their payout rate. The long-term, inflation-adjusted return on U.S. financial investments has averaged around 6% per year since 1870. Unless foundations can beat the market by a wide margin, they may not be able to sustain a payout rate between seven and 10 percent for very long without impacting their ability to fund in perpetuity. However, a researcher at the Urban Institute notes that veneration of perpetuity in philanthropy can, on occasion, be a substitute for careful reflection on moral or civic responsibility. One argument is that an insufficiently scaled response today may allow inequities to widen, making it more expensive to close gaps in the future.

Under current law, private foundations must disclose on their IRS Form 990-PF to which organizations funds are disbursed. However, private foundations can avoid disclosing the end recipient of their funds by distributing them through a DAF first. This action denies state and federal charity officials crucial information to help identify cases of self-dealing or abuse. Advocates for increased foundation and DAF transparency contend that the ACE Act's requirement for DAF 990 disclosure is an important step toward fostering trust in our sector.

Questions

1. How may regulatory reforms in the ACE Act or alternative policy proposals help DAFs and philanthropy give away not only money, but power?
2. What does research say about how compensation of large contributors or their family impact foundation governance and operations?
3. If voluntary payout at 7 percent or greater may reduce the long-term value of total investments, to what extent is the trade-off acceptable for a surge in resources flowing to charities today?
4. What policies are necessary to ensure state and federal charity officials have the information and resources needed to enforce laws and protect the sector against bad actors? Are there additional policy options to consider that may boost the public's trust in philanthropy?

Public Support Test

ACE Act Legislative Provision

For purposes of the public support test, anonymous contributions from a DAF are not considered to be from a public charity. If the name of the individual who advised the contribution is made available, the contribution will be treated as if it came directly from that donor.

Public Support Test Context & Questions

IRS rules require at least one third of a charity's revenue to come from the general public (i.e. donations) or government. This requirement is called the "public support test." Large grants from private foundations to small organizations could trigger the public support test and jeopardize their charitable status.

This provision may help increase DAF transparency and oversight by encouraging donors and DAF sponsors to voluntarily disclose their information to avoid placing the charity they support at risk of failing the public support test. However, some private foundations say DAFs help them avoid triggering the public support test when making sizable grants to small, community-based organizations.

Question

1. How effective may this provision be in incentivizing voluntary transparency in DAFs?
2. To what extent may the legislation impact the ability of private foundations or DAFs to diversify their grantee pool or adopt more equitable grantmaking strategies?

The summary and context provided in this document are intended to help nonprofit organizations understand the current debate around oversight and regulation of private foundation and donor advised funds. The document will be updated as Independent Sector learns of new information. In the meantime, if you have questions or feedback on this document or the legislation, please do not hesitate to contact Independent Sector at publicpolicy@independentsector.org.