

EFFECTIVE USES OF DONOR-ADVISED FUNDS

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■ INTRODUCTION

The next half-century is likely to see one of the largest inter-generational transfers of wealth in modern history, with the assets involved estimated at somewhere between \$41 trillion and \$136 trillion. That wealth transfer is expected to play an important role in a projected substantial increase in charitable giving, but it is not the only factor behind the emerging upturn in individual philanthropy. According to Paul G. Schervish, Director of the Center on Wealth and Philanthropy at Boston College and a Research Fellow at the Indiana University Center on Philanthropy, "More and more [people] have had their standard of living increase so dramatically that the exercise of free choice is the most dominant characteristic of modern American life."¹

Other researchers in the philanthropic community echo Schervish's findings. New Visions Philanthropic Research & Development recently completed the Donor Education Initiative (DEI), a two-year project examining the role of the individual donor in philanthropy. The opening sentence of the final report could not be more straightforward: "We are entering the age of the engaged giver."²

The DEI project identified a key trend that has emerged among a growing percentage of charitable givers over the past decade: Donors want to be better informed and more engaged in their giving than ever before. The DEI researchers predict this trend will intensify in the coming years, shaping a new generation of potential donors of all wealth levels who will use philanthropy to make an impact in their community, will be more intentional, will have a plan for how they give, and will practice philanthropy with guidance and support.³

An equally important trend from the perspective of advisors involved in charitable planning for their clients is the expanding role that donor-advised funds (DAFs) are playing in planned giving. Assets at DAFs tracked by *The Chronicle of Philanthropy* increased by 9.4% in 2003, new accounts were up 8.8%, and organizations offering DAFs increased their efforts to make more people aware of them.

Fundraisers polled by the publication predict even stronger results for 2004.⁴

Richard Day Associates, an independent research firm, conducted a research study on behalf of Fidelity Charitable Services® (FCS) to profile the advisor market and to identify where to focus priorities. 444 advisors were interviewed between July 30th and September 2nd, 2004. The study identified three distinct advisor groups:

Segment 1: Financial planners and registered investment advisors who are positively inclined toward DAFs, demonstrate a high level of familiarity with them, and recommend them often;

Segment 2: Seasoned, well-established attorneys and CPAs who are charitably-inclined themselves and;

Segment 3: Young attorneys just starting out and trying to build their practice.

■ RESEARCH-BASED VALIDATION IS MOUNTING

These and other related trends make it more important than ever that today's advisors have the ability to include charitable planning among the list of services they offer to their clients. At the very least, they should be able to refer clients to a trusted, reliable source for charitable planning if they choose not to offer those services themselves. Supporting these conclusions is a growing body of research, including the recent advisor study sponsored by FCS in the summer of 2004.

In September 2004, FCS completed a research study designed to understand the market for DAFs from both an individual and advisor perspective. Among the specific objectives of this research were to determine:

- How effective advisors work with clients to recommend a gifting strategy.
- The process advisors take when encouraging clients to use a DAF, and how they decide which programs to recommend.
- Any opportunities to enhance impressions of and

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experiences with the *Fidelity Charitable Gift Fund*SM.

The research was conducted in two stages. A qualitative study based on interviews with advisors who frequently recommend a DAF to clients was conducted in July 2004 and identified significant potential to increase DAF awareness through advisors. That was followed up with a quantitative study using telephone interviews conducted between July 30 and September 2, 2004. In both stages, a mix of advisor types were interviewed, including accountant/CPA/tax advisor, financial planner/CFA, lawyer/trust and estate planning attorney, and money manager/RIA.

■ STATE OF THE CHARITABLE GIVING MARKETPLACE

While there are some positive trends at play in the overall philanthropic market, penetration of charitable giving vehicles among clients who could benefit from them remains low. A trend of increasing optimism among fundraisers first reported at the start of 2004 continued through the summer. In June of 2004, the overall Philanthropic Giving Index (PGI) was up nearly 9% over December 2003's level and was more than 25% higher than the year-earlier mark.⁵

However, advisors participating in the FCS research indicated that only a fraction of their clients who have charitable or legacy planning needs currently have some sort of structured giving vehicle in place. This underpenetration has been the focus of much speculation and research. Among high-net-worth individuals who report facing obstacles to charitable giving, four roadblocks are cited most often:

- Lack of confidence that their donations will be used in a productive and valuable way.
- Have not found a compelling reason to give.
- Lack of time.
- Uncertainty about their own future financial situation.⁶

In many cases, there also appears to be a disconnect between advisor perceptions and client expectations. For example, when asked to rank their clients' motivations for giving, advisors in one study gave the top ranking to caring about a cause or institution (73%), followed by tax benefits (57%). However, the same advisors were far more likely to feel that tax savings are the primary reason for clients to engage in charitable giving.⁷

Advisors most likely to successfully work with clients on charitable planning solutions appear to have a number of traits in common, according to the FCS research. In general, they have been in business for 20 years or longer, and most appear to be charitably inclined themselves, as evidenced by personal use of charitable giving vehicles and active participation in charitable organizations and/or local community foundations. They have solid practices focusing on some aspect of the high-net-worth market, such as business owners or corporate executives; they actively work with between 40 and 400 clients; some set a minimum net worth level between \$5 million and \$10 million for new clients; and where they also manage financial assets, those assets range from \$700 million to \$2.5 billion.

■ TYPES OF CHARITABLE GIVING VEHICLES

While there are several different types of charitable giving vehicles available with differences such as tax treatment, there is also a fair amount of overlap and duplication in terms of the benefits and functionality they provide, which is one reason the advisor's role is so important in charitable planning.

- **Private foundations.** These generally allow donors to retain significant control over gifting and investment decisions, and they may provide substantial tax benefits. However, there are substantial administration and compliance requirements involved in starting and running a private foundation—violations of which may result in considerable taxes and penalties. For those reasons, many private foundation managers and their technical advisors choose to outsource administrative, record-keeping, and certain compliance responsibilities to a third-party provider.
- **Charitable remainder trusts (CRT).** A CRT provides current income to the donor or someone named by the donor in exchange for the irrevocable transfer of ownership of the trust's assets to a designated charity at the end of the trust's term. The donor gets an immediate gift tax deduction for the present value of the ending balance of the trust's assets that will be donated to charity.
- **Charitable lead trusts (CLT).** A charity designated by the donor gets immediate ownership of the trust's assets, along with the current income stream generated by those assets. At the expiration of the CLT's term, the remainder interest is either returned to the donor or

given to a non-charitable beneficiary designated by the donor, usually a family member. CLTs offer potential tax benefits to the donor, but they differ in some ways from CRTs and can be more complex.

- **Pooled income funds.** This is a form of charitable trust established and run by a qualifying nonprofit organization. It provides a lifetime stream of income to donors based on their share of the fund's earnings, with donors getting an immediate tax deduction based on life expectancy and anticipated income stream. Annual income from the fund is taxable. Pooled income funds offer a way to convert appreciated assets into income without becoming liable for capital gains taxes. A designated charitable beneficiary receives the balance in the fund at the donor's death.

■ DONOR-ADVISED FUND PROGRAMS

Another option, one that is rapidly growing in popularity, is the donor-advised fund offered through a public charity. A DAF can be an excellent charitable solution for donors who want the tax benefits that flow from charitable giving, but also want a simpler way to support the charities they care about. The tax benefits provided by a DAF can include an immediate income tax deduction, avoidance of capital gains taxes if the gift is appreciated property, and a reduction in the donor's gross estate equal to the amount of the excluded asset.⁸ Other advantages of a DAF program include:

- Low contribution minimums.
- Easy to establish.
- Cost-efficient.
- Timing of gifting vs. deductions.
- Minimal demand on donor's time and energy.
- High level of support and service; DAFs generally handle all reporting and compliance requirements, screen charitable recipients for 501(c)(3) eligibility, and provide grantmaking support.
- Flexibility to support multiple charities simultaneously.
- Ability to give anonymously, if desired.
- Can be set up to continue in perpetuity, involving later generations and creating a legacy of family philanthropy.

DAFs appeal to a wide range of donors and potential donors and can be structured to meet an equally wide range of donor needs. They present few drawbacks in most cases, with their primary limitation existing in the

area of donor control. While donors recommend grant recipients, the sponsoring organization retains final authority over the distribution.

■ ADVISOR PERCEPTIONS AND USES OF DAFS

Most advisors interviewed in the FCS research have a range of giving vehicles they consider when providing charitable planning services to clients, but they rate DAFs as being the most flexible and appropriate for a variety of different situations. Situations where top-performing advisors frequently recommend a DAF include:

- Any client who contributes sufficient sums to charity on a regular basis.
- Clients with appreciated stock who want to control the timing of the gift or the timing of the tax deduction, including clients who want to take the deduction in a given year, but do not yet know where they want their contribution to go.
- Clients with significant assets who do not want to get involved in the charity or wish to donate anonymously.
- Parents or other relatives who want to provide a legacy of charitable giving for their children.

Top-performing advisors in the FCS study also expressed an overwhelming preference for the *Fidelity* Charitable Gift FundSM among all DAF programs. Launched in 1992, the *Fidelity* Charitable Gift Fund has made total grants of \$4.4 billion benefiting some 84,000 nonprofit organizations nationwide, making its one-millionth grant in August, 2004. Through the first half of 2004, the Fund saw a 31% increase in donor contributions and a 52% increase in the number of new Giving Accounts[®] established, compared to the same period in 2003.⁹

Advisors in the FCS study said they were aware of the Gift Fund's market leadership, and said they felt comfortable recommending the *Fidelity* Charitable Gift Fund. They also gave the Gift Fund high marks for ease of start-up and administration, quality and effectiveness of Fund-related materials, and investment options offered by the Gift Fund. Advisors reported consistently positive experiences with the Gift Fund and were particularly appreciative of the Gift Fund's advisor services and support, citing the Gift Fund as the only donor-advised fund currently working with advisors to meet their clients' needs.

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Conclusion

After slowing a bit at the start of the decade, growth in charitable giving is once again on the rise. The massive inter-generational transfer of wealth already underway is forecasted to swell nonprofit coffers by some \$6 trillion by 2055, with \$1.7 trillion of those donations occurring over the next 20 years.¹⁰ The ranks of individuals who could benefit from planned giving are also swelling, creating tremendous charitable planning opportunities for advisors that, thus far, remain largely unmet. One-third of professional fundraisers rate donor-advised funds among the most successful planned-giving techniques, and 46% expect them to become even more successful in the future.¹¹ Clearly, DAFs can and should play a pivotal role for advisors in starting, building, and maintaining a charitable planning component in their practices, both now and in the future.

FOOTNOTES

¹ “Wealth Transfer in an Age of Affluence,” interview with Paul G. Schervish, Ph.D., in Spring 2003 issue of *More Than Money Journal*.

² “Philanthropy’s Forgotten Resource? Engaging the Individual Donor,” final report of the Donor Education Initiative, New Visions PRD, 2003.

³ *Ibid.*

⁴ “Donor Funds Are on the Rise Again,” article in May 27, 2004 issue of *The Chronicle of Philanthropy*.

⁵ Philanthropic Giving Index, Summer 2004; the PGI is a semiannual study of the climate for philanthropic giving and fundraising in the U.S. conducted by The Center on Philanthropy at Indiana University.

⁶ “The High-Net-Worth Landscape and Opportunity,” March 2002 presentation by Vin Cipolla, chairman and CEO of HNWI, Inc.

⁷ “Doing Well by Doing Good—Improving Client Service, Increasing Philanthropic Capital: The Legal and Financial Advisor’s Role,” report by The Philanthropic Initiative, Inc., June 2000.

⁸ “Philanthropy 101: Donor-Advised Funds,” article by Elfrena Foord, CFP, in November 2003 issue of *Journal of Financial Planning*.

⁹ Fidelity Investments Charitable Gift Fund press release, August 5, 2004.

¹⁰ “Family Philanthropy and the Intergenerational Transfer of Wealth,” report published by the Council on Foundations Community Foundation R&D Incubator, 2003.

¹¹ Philanthropic Giving Index, Summer 2004.

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