Pacific Community Ventures


# Policy Brief:
## Unlocking Donor-Advised Fund Capital for COVID-19 Recovery

October 2021

# Foreword

**Bulbul Gupta**
President & CEO

COVID-19 has drawn attention to systemic racial and economic injustice in the United States of America, yet over this unprecedented year the racial wealth gap has widened even further and too many BIPOC-owned small businesses have permanently shut down after being denied or simply not qualifying for sustaining capital. Federal stimulus packages channeled billions of dollars in aid, but much of that effort never reached communities of color — only 2% of Black-owned businesses and 7% of Latinx-owned businesses received PPP loans. This was not a surprise to many of us in the CDFI industry, who worried that deploying PPP initially through the large banks, most disconnected from BIPOC small business owners, would continue to leave them behind. Now is the time to broaden how we think about philanthropy and what can be possible with large-scale investments from private donors put toward social and economic justice. If we truly want to shape a more inclusive recovery than we did post-2008 Great Recession, this is the time for philanthropy to be truly catalytic capital for systems change.

One mechanism ripe for such change is Donor-Advised Funds, or DAFs. A DAF is a philanthropic vehicle that allows donors to make charitable contributions and then recommend grants from the fund. DAF money is committed to charitable purposes, but currently, donors can sit on those funds as long as they like, having already received a tax benefit at the time the money went into the fund. As a result, DAF donors and sponsors are leaving billions of dollars already committed to charitable purposes on the sidelines–approximately $142 billion.

Why is all that money sitting passively a year and a half into this economic crisis when low-income and communities of color continue to struggle with social and economic vulnerabilities? Where are the strides to deploy equitable investments when so many of those same asset owners keep saying they want to support racial and economic justice?

In short, our hypothesis is status quo: people respond to incentives, and the right incentive doesn't exist to get that money moving quickly. The vast majority of DAFs are invested in traditional exchange-traded funds (ETFs) managed for growth. While that growth means there will be more money for charitable purposes down the line, in theory, it also means that present-day effective investments in communities — investments that could immediately transform lives beyond what an ETF does — are not happening. The result is a perpetuation of the status quo, which we know inherently worsens wealth disparities in the U.S. Further, the DAFs could be exposed to ETF investments that negatively impact people and the planet, undermining donors' charitable goals.

That is why we are proposing a temporary incentive to kickstart catalytic investments in specific areas of need to aid in COVID-19 recovery. The credit would drive the creation of impact investing infrastructure within the DAF industry — helping to institutionalize the systems, practices, and relationships needed to channel billions of dollars currently sitting in traditional investments into undercapitalized social enterprises, CDFIs, affordable housing creation, and economic development initiatives in low-income communities.

This is a temporary solution created to address the pressing needs of the unique economic moment we are in. DAFs need a more sustainable fix. Our team at PCV is hopeful about the Accelerating Charitable Efforts (ACE) Act, proposed by Senators Angus King and Chuck Grassley, and its requirement that all DAF funds must be distributed within 15 years for donors to claim the full tax deduction. And while we would be hesitant to propose an additional tax incentive for DAF holders, we need to catalyze this charitably oriented money in the immediate future if we are going to shape the more inclusive recovery we all talk about, and our communities truly need. That's why this incentive is temporary and targets those actively engaged with DAF-sponsoring organizations themselves, rather than passive holders.

By acting now to improve the infrastructure for impact investing within the DAF industry, we can lay the groundwork for inherited wealth from future donors to flow to BIPOC communities and into restorative causes that advance economic justice. We cannot let our momentum for change be eclipsed by inactivity and the wrong incentives — keeping low-income and communities of color continually excluded from opportunity. This is a historic opportunity for systems change, and this is the right time.

In solidarity,

**Bulbul Gupta** (she/her)
**President & CEO**
Pacific Community Ventures

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## About the Author

**Pacific Community Ventures (PCV)**, a nonprofit community development financial institution (CDFI) based in Oakland, California, envisions a world of thriving communities where everyone has a fair shake. Our mission is to invest in small businesses, create good jobs for working people, and make markets work for social good. We achieve our mission through a "Good Jobs, Good Business" model that combines affordable loans with pro-bono advising; our BusinessAdvising.org platform, impact measurement, evaluation and research; and tools and small grants to create good-quality jobs that address racial and gender wealth gaps.

This policy brief was developed by PCV's Research and Consulting team, which leads projects intended to foster the growth and increase the efficacy of the impact investing field. PCV's experience in impact investing policy has both inspired and informed this research. Since 2009, PCV has examined the role that public policy has played in supporting the development of impact investing globally. In partnership with the Initiative for Responsible Investment (IRI) at Harvard University, PCV developed a framework for policy design and analysis that was used globally to develop and implement impact investing policies. PCV and IRI also worked together through the Impact Investing Policy Collaborative to engage investors and policymakers to foster a global conversation on the role that policy could play in enabling impact investing's growth – contributing research and knowledge to the G8 Social Impact Investment Taskforce. More recently, PCV and IRI collaborated with Enterprise Community Partners through the Accelerating Impact Investing Initiative (AI3) to support impact investing policy in the U.S. PCV has also examined federal policy as part of our research and work with investors and businesses on job quality to encourage investments in quality job creation, as well as with federal and state policymakers to improve impact investing and community development practices and foster an enabling environment for private capital to be channeled towards public purpose.

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# Executive Summary

*Donor-Advised Funds (DAFs) present an enormous and largely untapped source of private capital for responding to the unprecedented challenges created by COVID-19 in the U.S. While DAFs are charitable giving vehicles, a majority of DAF assets sits on the sidelines of impact, with some invested in traditional funds without screens for environmental, social, or governance (ESG) issues.*

With no requirement to disburse grants on any given timeline, many DAF sponsors keep the capital invested in growth-oriented vehicles from which donors may only periodically advise that grants are made. Given the scale of the nation's challenges, it is past time that DAF capital was invested for meaningful, measurable impact before and in addition to being disbursed as grants to charities.

This brief presents an overview of a proposed temporary tax credit designed to attract DAF donors to impact investing to support institutions and communities working to rebuild the economy. Partly modeled on the market-building electric vehicles tax credit,[1] the proposed credit is designed to drive up the use of impact investments to meet the needs of communities still reeling from the effects of COVID-19 while accelerating impact investing more broadly within the DAF industry to bolster its effectiveness. Capped at a flat amount and tied to specific, verifiable impact investments, the credit would drive donor interest, particularly among younger donors and those with modest-sized DAFs, without becoming a permanent fixture of the tax code.

In the longer term, the credit has the potential to demonstrate that impact investments from DAF accounts can — and should — serve as a source of catalytic capital that can attract greater private investment to areas of systemic need in the economy.[2] Investments from DAFs could function as the crucial, concessionary piece of blended finance arrangements that advance restorative justice, such as investments in CDFIs serving communities facing systemic barriers to capital access. As contributions that donors have earmarked for charitable purpose — and like program-related investments, capital that can be utilized for concessionary and more flexible investments to advance charitable purpose — DAFs represent an enormous, unrealized opportunity for community investing in support of racial and economic justice.

With impact investments, DAF sponsors and donors will be able to leverage every tool at their disposal to further donors' charitable goals. As capital set aside for the benefit of society — and for which donors already receive a substantial tax deduction — DAF assets should be put to work for greater societal good and not sit dormant or be invested in ways that counteract donors' charitable purposes.

With a temporary, targeted tax credit, policymakers can leverage the sizable and growing assets of DAFs to support COVID-19 recovery in the immediate term and lay the groundwork for longer-term change within the DAF industry.

This proposal was informed by interviews with current and former community foundation and national charity staff, impact investors, tax policy experts, academics, researchers, and others. The views expressed here do not necessarily reflect the views of the interviewees. For a full list of experts interviewed as part of this research, see Appendix A.

# Introduction

*As the country continues to grapple with the COVID-19 pandemic and the systemic inequities it has laid bare, DAF donors and sponsors are leaving billions of dollars already committed to charitable purpose on the table.*

While some DAF sponsors have pushed their donors to ramp up charitable giving during the pandemic, too few options have been made available for donors to place capital in impact investment products to complement grantmaking and meet the needs of the moment.

Impact investments from DAFs could support social enterprise growth, affordable housing development, small business lending, healthy food access, and other under-resourced initiatives with the potential to uplift particularly BIPOC and low- to moderate-income communities. Impact investments would, in turn, generate a financial return that expands the pool of capital available to the donor for future charitable giving.

Furthermore, as DAF capital is already committed to charitable purpose, these investment dollars are inherently more flexible than traditional investments: donors can accept lower rates of return and provide much-needed risk and/or patient capital to socially beneficial businesses and economic development initiatives that further donors' charitable goals.[3] DAFs have the potential to function as catalytic capital, flexible investments that often generate below-market-rate returns while unlocking billions of additional investment dollars from more risk-averse sources of private capital. Despite this enormous, unrealized potential, the vast majority of DAFs today are invested passively in traditional exchange-traded funds (ETFs) managed for growth and potentially exposed to investments that negatively impact people and the planet, undermining donors' charitable goals.

A targeted, timebound tax credit for impact investments made with DAFs has the potential to direct capital that is sitting on the sidelines towards critical social and environmental areas of need, especially in response to COVID-19. In the absence of regulations or incentives to invest DAF assets for impact today, policymakers miss an opportunity to leverage a massive pool of untapped private capital for economic recovery. New incentives could encourage new and existing DAF holders to put more of their money to work for good before, and in addition to, grantmaking.

The tax credit could be used to provide "proof of concept" to the DAF industry as it generates new investments in COVID-19 recovery efforts and other immediate areas of need. Early wins during the lifespan of the credit would lay the groundwork for DAF sponsors to create more impact investing opportunities for their clients, all while demonstrating to current and future donors the power of aligning their DAF portfolio with charitable purpose. Without a concerted effort to expand impact investment options for DAF donors, sponsors may miss out on the next generation of donors who are committed to supporting social and environmental causes in their personal and professional lives and have already demonstrated notable interest in impact investing.[4]

# Background

*Donor-Advised funds (DAFs) are an increasingly popular philanthropic tool that offer individuals the option to create an endowed grantmaking vehicle managed by a third party, nonprofit organization.*

An individual may open a DAF account with a DAF sponsor — often a community foundation or national charity (typically the nonprofit arm of a financial management firm, such as Vanguard, Schwab, or Fidelity) — and receive an immediate tax deduction equal to the amount of their contribution (subject to IRS limitations). Donors who give appreciated assets can also defer capital gains taxes on their contributions to a DAF. Once a DAF is created, the donor cedes all rights to the underlying capital, and the DAF sponsor invests and manages the account for growth. The donor maintains the right to direct all grantmaking from the fund personally or through an appointed advisor.

According to the National Philanthropic Trust (NPT), a nonprofit organization that publishes annual analyses of the DAF market, DAFs comprised $141.95 billion in charitable assets under management by the end of 2019, when the latest available data was compiled.[5] This amount represents a 16% increase over the previous year. NPT reported that contributions to DAFs totaled $38.81 billion in 2019, while grantmaking to qualified charities from DAFs was over $27 billion.[6]

Amidst their growing popularity, DAFs have been criticized for the disconnect between donors' receipt of tax benefits and the actual deployment of DAF dollars towards charitable purposes. Under current law, donors receive an immediate tax deduction equal to the value of their donation upon contributing to a DAF without having to disburse any grants; in essence, the tax benefit is tied to the promise of future charitable activity as opposed to charitable activity itself. In addition, transfers from one DAF to another are counted the same as grant disbursements under current practices, muddying the calculation of how much DAFs pay out annually and making it difficult to differentiate actual charitable giving from the shifting of funds. As has been noted in some academic literature on payout calculations, this reality risks inflating the amount of charitable activity from a DAF sponsor and double-counting charitable gifts.[7]

Unlike private foundations that must disburse the equivalent of 5% of their net assets annually to maintain their tax-exempt status, at present, there are no legal requirements for DAF donors to make any charitable contributions once they open a DAF. Critics of the DAF industry have pointed to a need to establish annual charitable giving mandates or sunsetting periods for DAF accounts to ensure that DAFs are actively and maximally used for generating social and environmental good. In June 2021, Senators Chuck Grassley (R-IA) and Angus King (I-ME) introduced the **Accelerating Charitable Efforts Act (ACE)** that would apply time limits to DAFs, requiring sponsors to distribute DAF funds within 15 years in order for donors to claim the full tax deduction. Should donors wish to spread their donations out over a longer time, they would be allowed up to 50 years but could only take the full tax deduction at the end of that period.[8]

## THE NEED FOR FEDERAL POLICY ACTION

While much attention has been paid to the grantmaking activities of DAFs, these charitable giving vehicles also represent a crucial opportunity for transformative, impact-oriented investments, particularly as the nation works to rebuild from the fallout of COVID-19. Typically, DAFs are invested by community foundations or national charities with fairly traditional portfolio management strategies. Donors are sometimes given the option to place their funds in products screened for ESG considerations, but rarely are they offered the chance to invest in impact-oriented products. Even before grants are disbursed, donors ought to ensure their funds are invested in a manner that does not undercut their charitable goals and actively generates positive social and environmental impact.

In addition to responding to current needs across the country, impact investing represents a crucial, long-term opportunity that DAF sponsors would do well to embrace. Fidelity Charitable, the largest grantmaking charity in the nation, reported in 2020 that Millennials accounted for 13 percent of all their new DAF account holders in 2019 — more than double the percent from five years prior.[9] While they are presently a minority of all DAF account holders, Millennials are set to inherit an estimated $68 trillion in wealth from their parents within the next 25 years.[10] As their predecessors have, many wealthy Millennials will likely look to DAFs as giving vehicles. Even more than their predecessors, Millennials will bring to bear on the industry their well-documented interest in investing their money for social and environmental benefit.[11] To prepare for this wealth windfall, DAF sponsors should build impact investing into their investment strategies today.

The DAF industry has slowly begun to recognize and respond to growing interest in impact investing. Within the last few decades, financial advisory and management firms that help donors and DAF sponsors invest capital for impact have grown in number and size. Firms such as RSF Social Finance, ImpactAssets, and Capshift either create options directly for their donors or curate impact-oriented products for other DAF sponsors. While an indication of changes within the DAF world, these firms' activities represent only a small subset of the DAF industry.

As policymakers consider how best to maximize DAFs as a charitable tool, the untapped potential of DAF assets should not be overlooked. A temporary tax credit can encourage the development of new investment options that further donors' charitable interests by stimulating donor demand for impact investments that support COVID-19 recovery efforts across the country. Furthermore, the limited credit could attract additional donors to the DAF space and pave the way for Millennials and the next generations of donors. Most significantly, the credit would direct DAF capital out of traditional investments that may cancel out donors' charitable giving and into investments that generate social and environmental benefits.

## IMPACT INVESTING TAX CREDIT PROPOSAL

To harness DAF capital for investments that create social and environmental good, the federal government could offer a one-time tax credit of $10,000 to donors who direct their DAF sponsor to invest at least $20,000 of their DAF in qualified impact investments, to be paid in the tax year in which the donor directs capital to the investment. Each donor could only access the credit once, and only for new, qualified impact investments. Credits could not be applied retroactively to existing investments, even if they meet the criteria of a qualified investment (described below). Sponsors would be required to keep the funds in the qualified impact investment(s) until the donor is ready to disburse them in the form of charitable grants.

A total tax expenditure cap could be applied to further boost demand for the credit and guard against overuse of the tax credit. Numerical caps could also be applied at the individual sponsor level, similar to the federal electric vehicles tax credit, ensuring equitable distribution of tax credits across community foundations and national charity DAF sponsors. However, more research would be required to ensure an overall tax expenditure cap and numerical caps at the DAF sponsor level would be sized appropriately and not impede DAF impact investment activity.

New, qualified impact investments eligible for the credit would include:

1. Impact investments included on the Global Impact Investing Network IRIS+ List[12]
2. Impact investment funds that are signatories to the IFC Operating Principles for Impact Management and have issued a disclosure statement[13]
3. Investments in past or current ImpactAssets 50 Members[14]
4. CDFI Investment Products, such as:
    a) CNote[15]
    b) Direct investments in CDFIs[16]
5. B-Corp[17] certified Social Enterprises and Investment Products
    a) Calvert Impact Capital Community Investment Notes[18]
    b) RSF Social Investment Fund Note[19]
6. Other impact investments that have a clear link to:
    a) COVID-19 recovery efforts
    b) Local community and economic development, particularly in BIPOC communities
    c) Climate resiliency

Sponsoring organizations would need to provide documentation on these investments annually to the IRS. The IRS would verify that the investments meet the criteria of qualified impact investments.

The tax credit would coincide with economic recovery efforts over the next few years, providing a critical source of investment capital from funds already earmarked for charitable purpose. Despite sizable need, impact investing has grown only modestly during COVID-19. Among other indicators, the International Finance Corporation found that fewer than half as many new impact funds were created in 2020 compared to 2019.[20] More capital is needed to support recovery efforts and meet the urgent national challenges magnified by the pandemic.

In addition to directing capital to areas of need in the short-term, the five-year time horizon of the credit is designed to generate enough donor interest over a sufficiently long period to provide "proof of concept" to the DAF industry of the viability and appeal of impact investments. The credit, capped at $10,000, would target less wealthy donors who do not itemize their tax deductions and would be attracted to a direct, flat payment.

With additional interest in impact investing from donors, DAF sponsors would integrate impact investing within their menu of available investment options and help donors achieve greater social and environmental benefit with their charitable dollars. The credit could also spur longer-term demand for impact investment products within DAFs and the overall wealth management industry, paving the way for impact investments to become more mainstream.

# Conclusion

*DAFs are giving vehicles designed to create meaningful social and environmental benefits in exchange for their tax-advantaged status. Yet, the vast bulk of wealth housed within DAFs sits in traditional investment portfolios, treated largely as separate from DAFs' intrinsic purpose.*

Even as market innovators have emerged to introduce impact investing options within DAFs, take-up of these options has been sluggish — even at a time of unprecedented need. As the nation grapples with the effects of COVID-19, DAF sponsors are well placed to leverage their considerable assets for transformative impact. As policymakers consider further recovery measures, they should act on opportunities to utilize the estimated $141.95 billion in DAF assets under management already earmarked for charitable purpose, maximizing these vehicles' potential as a philanthropic tool.

To spur DAF sponsors to adopt investment options that promote economic recovery, particularly for BIPOC- and women-owned businesses and low- to moderate-income communities, the federal government could offer a temporary tax credit tied to qualified impact investments. Capped at a flat amount and expiring after five years, the credit would generate new interest in impact investing among current and prospective donors and prompt the DAF industry to make available options investing for impact alongside a financial return. Returns generated on investments of at least $20,000 in qualified impact investment vehicles would continue to grow DAF assets prior to their payout as grants to charitable organizations. The credit has the potential to attract new donors in the short term, while preparing DAF sponsors to harness the giving capacity of the next generation of donors. Most importantly, the credit would direct private investment to areas of national need, tapping into a vastly underutilized source of capital already set aside for charitable purpose.

# Appendices

## Appendix A:

### Experts Consulted

| Name | Role | Organization |
|---|---|---|
| Beth Bafford | Vice President | Calvert Impact Capital |
| Alan Cantor | Principal | Alan Cantor Consulting LLC |
| Rob Collier | Retired President & CEO | Council of Michigan Foundations |
| Gina Dalma | Executive Vice President - Community Action, Policy & Strategy | Silicon Valley Community Foundation |
| Pamela Doherty | Senior Director of Gift Planning | San Francisco Foundation |
| Mark Doherty | Senior Director of Investments | San Francisco Foundation |
| Nicolas Duquette | Associate Professor | University of Southern California Sol Price School of Public Policy |
| Rodney Foxworth | CEO | Common Future |
| Tim Freundlich | Founder & Executive Director, Strategic Development | Impact Assets |
| Sarah Gelfand | Managing Director | BlueMark |
| Mary Scott Hardwick | Senior Associate, Policy | Opportunity Finance Network |
| Jackie Khor | Vice President | Social Finance |
| Ray D. Madoff | Law Professor | Boston College |
| Katherine Pease | Managing Director | Pathstone |
| Stephanie J. Powers | Senior Advisor, Public Policy & Partnerships | Council on Foundations |
| Valerie Red-Horse Mohl | Chief Financial Officer | East Bay Community Foundation |
| Liz Sessler | Managing Director, Product & Partnerships | CapShift |
| Tanya Shadoan | Managing Director of Impact Investing & Philanthropy Operations | Jewish Community Federation & Endowment Fund |
| Beth Sirull | President & CEO | Jewish Community Foundation of San Diego |
| Michael Swack | Director | Center for Impact Finance, Carsey School of Public Policy, University of New Hampshire |
| Jennifer A. Vasiloff | Chief External Affairs Officer | Opportunity Finance Network |
| Shu Dar Yao | Founder & Managing Partner | Lucid Capitalism |

# Appendix B:

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