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Written Submission to the Senate Special Committee on the Charitable Sector
(Oral Testimony Provided on September 24, 2018)

Thank you for the invitation to provide testimony today to this Special Senate Committee on the Charitable Sector ("the Committee"). I have been following the work of this Committee with great interest and admiration and it is an honor for me to contribute to this important undertaking.

My name is Ray Madoff and I submit these comments in my individual capacity. I am a professor from Boston College Law School in the United States and the co-founder and director of the Forum on Philanthropy and the Public Good, a nonpartisan think tank that focuses on issues of philanthropy and charitable tax policy.

I bring a cautionary tale from the United States, with the hopes that Canada will take steps to adopt rules to protect Canadian charities and the beneficiaries they serve, as well as protect government resources from imprudent tax expenditures.

There are many similarities between the Canada and the United States. Both countries seek to promote a robust charitable sector and both use the tax system to incentivize charitable giving. We also face similar trends: an overall decline in giving in the population, and more concentration of giving by the wealthy. Because the wealthy are more likely to structure their giving in tax-advantaged ways, it is particularly important that tax rules be regularly re-examined to ensure that they are incentivizing the right thing.

My comments focus on two areas where I believe you need to be particularly mindful of the details in fashioning incentives: donor-advised funds and extending capital gains tax relief to contributions of private company shares and real estate.

My suggestions are that in order to protect charities and government resources it is important that (1) rules be provided to ensure that donor-advised funds be distributed outright to charities within a reasonable period of time; and (2) any extension of capital gains tax relief beyond publicly traded stock be carefully drafted to avoid abuse and problems of oversight. This written testimony includes specific suggestions for how these goals can be accomplished.

Donor-Advised Funds

Donor-advised funds have become a dominant force in charitable giving in both Canada and the United States. The growth has been particularly staggering in the United States where Fidelity Charitable is the most popular charity by far (with donations in 2016 surpassing all other charities by more than 20%), and where six of the top ten fundraising charities are donor-advised fund sponsors.

The reason for the popularity of donor-advised funds is that they provide donors with the double benefit of effective on-going control over donated funds, combined with maximum tax benefits. Donor-advised funds are particularly advantageous from a tax perspective because they facilitate gifts of appreciated property, which saves both income and capital gains taxes.

Donor advised funds can be confusing to talk about because there is a disconnect between their legal structure and how they operate in practice. Legally, a transfer to a donor-advised fund is structured the same as any outright transfer to any registered charity. The donor legally gives up all control over the donated property, including the ability to direct charitable transfers from the donated funds. This is what enables donors to get current tax benefits for their transfer.

But despite these legal agreements, the reason people create donor-advised funds is because the charity, in a non-legally binding way, gives the donor effective on-going control over the charitable disposition, and sometimes investment, of the donated assets. This is why a recent Canadian journal described donor-advised funds as "similar to creating your own private foundation, but simpler."[1] And why other people describe donor-advised funds as "charitable checking accounts."[2]

In this way, donor-advised funds sit in a nether-region between private foundations and outright gifts to charities: they feel like private foundations to the donors, but are not subject to payout, disclosure and oversight rules otherwise applicable to private foundations. They provide the tax benefits of outright gifts to charities, but no charity is given true control over the donated funds, and the donor is under no obligation, and no incentive, to <u>ever</u> make charitable distributions from his donor-advised fund. ***This failure to require payout means that donor-advised funds have effectively severed the ties between charitable tax benefits and benefits to charities.***

It is important to note that this problem with DAFs is not about bad people, it is about bad policies. There are many reasons why well-meaning donors may fail to make significant distributions from their DAFs, including the following:

1. Charitable decisions are difficult to make, and many donors have busy lives and therefore want to defer decision making. This common desire to defer decision making until absolutely necessary is evidenced by the number of charitable gifts that occur in the final days of the calendar year. By allowing donors to get the full tax

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[1] Terry Smith, "Donor Advised Funds: Easy, Quick, Smart!" Your Guide to Charitable Giving and Estate Planning. https://www.globalphilanthropy.ca/images/uploads/Your_Guide_to_Charitable_Giving_and_Estate_Planning.pdf

[2] For one of many examples, see https://www.daytonfoundation.org/ccaserv.html.

benefits of giving without requiring outright (i.e., non-DAF) transfers of charitable assets, donors may never feel the need to disconnect from their DAF accounts.

2. Behavioral economists have noted that people can feel good watching their donor-advised fund grow—similar to how they feel watching their retirement funds grow. Similarly, due to the endowment effect, donors may experience a sense of loss when their DAF accounts go down as a result of charitable distribution from their DAFs.[3] Where this desire to preserve funds may work well in the retirement savings area, it goes against the policy underlying charitable tax benefits: to get money to charities so that funds can be put to use.

3. The fact that DAF sponsors and financial advisors benefit financially when assets remain in the DAF may cause them to subtly encourage donors to think of DAFs as accounts to hold rather than as funds to disburse. One way that sponsors and financial advisors may do this is to encourage donors to think of DAF funds as a charitable legacy to be passed on to younger generations.[4]

In order to counter these tendencies, Parliament should adopt rules that either delay some of the charitable tax benefits until funds are distributed out of the DAF, or require DAFs be distributed within a reasonable period of time from contribution.

Tie Benefits to Distribution. Parliament could incentivize distributions from DAFs by tying some of the charitable tax benefits to the release of DAF funds. For example, Parliament could enact rules that would allow donors to avoid capital gains on transfers of property into DAFs, but would delay the charitable deduction until such time as funds are distributed from the DAF to non-DAF beneficiaries.

Set a Time Period for Payout. Parliament could impose a maximum time period for DAF accounts to be distributed outright to charities. This could easily be accomplished by requiring donors, as a condition of the deduction, to name a non-DAF charity that would receive any undistributed funds at the end of the designated period. For example, if Parliament were to impose a maximum time period of ten years, then a donor who funds a DAF in 2018 would be required to name a charity that would receive any remaining funds in the 2018 DAF account by 2028. DAFs would maintain their flexibility because donors could change their charitable designations by simply making distributions from that account before the termination date. A maximum distribution period would not undermine the effectiveness of DAFs or their appeal to donors. It would simply establish a limit that would ensure that tax-benefited dollars are granted outright to nonprofits within a reasonable period of time.

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[3] James Andreoni, "Warm Glow and Donor-Advised Funds: Insights from Behavioral Economics." https://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1016&context=philanthropy-forum

[4] https://www.rbcwealthmanagement.com/us/en/research-insights/leaving-a-charitable-legacy-with-donor-advised-funds/detail/

Proposal to Extend Capital Gains Tax Relief to Contributions of Real Estate and Private Company Stock

The second issue I'd like to discuss is the proposal to extend capital gains tax relief to contributions of private company shares and real estate. I understand that under current Canadian law, this benefit is limited to publicly traded stock, but that some have expressed interest in extending this benefit to private company shares and real estate with the hope that this expansion will bring additional charitable resources to the sector.

From what we have seen in the United States, I suspect this will be the case. Not just because owners of real estate and private business interests are likely in a position to make large charitable gifts, but also because in the United States, the donor-advised fund industry has focused on these types of assets to grow their funds. I suspect that if Canadian law were to provide this expansion, Canadian donor-advised fund sponsors would follow suit and you would see a similar explosion in both donor-advised funds and contributions of real estate and private company shares.

However, in fashioning this extension, I urge the legislature to learn from our mistakes. For while this rule has encouraged donations of assets that otherwise would not be contributed to charity, it has come at a significant cost to the government. That is because under US law, taxpayers are entitled to charitable tax benefits based on the appraised value of the donated property at the time of contribution. Since these assets have no easily identified market value, and often no market, everyone is dependent on the donors' hired appraisers to determine that value and it is virtually impossible for the government to provide sufficient oversight on their work. More troubling is the fact that the in the United States, donors' tax benefits are based on the value of the property at the time of contribution, even though a significant portion of that contribution may go to brokerage fees and other expenses of converting the property to cash.[5] Depending on the time it takes to sell the property and the costs associated with the sale, the tax benefits of contributions for the donor can far outweigh the benefit to the public from the charitable gift.

If the Parliament chooses to extend capital gains tax relief to contributions of private company shares and real estate, I urge you not to adopt a system that relies on appraisals. Instead, any charitable tax benefits should be tied to the amount of charitable funds ultimately made available for distribution after the sale of the property.

[5] Consider the case of a donor that has a condominium in an area where the market is currently depressed. Assume the condominium has an appraised value of $500,000. After donation, the DAF sponsor may have to pay significant fees associated with the property, such as property taxes, utilities, and condominium fees, and the eventual sale of the property will require payment of transfer taxes and real estate brokerage fees. After all of these expenses are paid, only $400,000 is allocated to the donor's DAF even though the donor was allowed to take a tax deduction based on a $500,000 appraised value

One way of doing this is to adopt the proposal made in the 2015 budget which provided that if an owner of private company shares or real estate sold the assets to an arm's length party and donated the cash proceeds to a registered charity within 30 days, he or she would be able to exempt from any capital gains tax on that portion of the cash proceeds that were donated to a charity.

However, there may be pressure to extend this benefit to contributions of property itself (rather than proceeds from the sale of property.) If that is allowed, it is very important to limit the charitable tax benefit to the amount of cash that ultimately ends up in the DAF account.

I hope that my comments are helpful to you in adopting rules to ensure that charitable tax benefits provide maximum benefits—not just to donors-- but to Canadian society as a whole. In doing so, you will provide valuable leadership beyond Canada, to the United States and the world at large.

Please let me know if I can provide any assistance going forward. I can be reached by email at madoffr@bc.edu and by telephone at 617-552-0926.