How Donor-Advised Funds Work—and Don't Work

Costly Mistakes Can Hurt a Popular Method of Giving

By VERONICA DAGHER

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Donor-advised funds are a popular and easy way for many investors to give to charity. Still, some people don't fully understand how the funds work, and that can lead to costly mistakes.

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The concept is simple. The donor makes a tax-deductible contribution to the fund. The fund managers, which include some of the biggest investment companies, then carry out a dual mission of seeking positive returns on the assets, while making distributions to charities designated by the donor.

Contributions to the funds themselves are deductible at up to 50% of adjusted gross income, compared with a 30% limit on contributions to some private foundations. The fund's managers take on the paperwork duties, and thus some of the headaches.

Moreover, the funds' investments can grow tax free, leveraging the donor's ability to make more charitable gifts over time.

To be sure, the funds do charge fees. And there are no guarantees that the investments in their portfolios will perform well. But what concerns some financial advisers even more are the kinds of misunderstandings some clients continually show when it comes to donor-advised funds.

"When it comes to donor-advised funds, ignorance is not bliss," says Andrew Altfest, executive vice president of Altfest Personal Wealth Management in New York.

Fatter Funds

Total contributions to donor-advised funds rose 34.6% from 2011 to 2012.

	2012	2011
Assets under management (in billions)	$45.35	$38.14
Total contributions	$13.71	$10.19
Total grant dollars	$8.62	$8.08
Average account size* (in thousands)	$224,921	$202,341
Payout**	16%	17.50%
Total number of accounts	201,631	188,487

* Grant dollars divided by (assets under management at year-end + grant dollars) x 100.

** Total assets under management divided by the total number of donor-advised fund accounts.

Source: National Philanthropic Trust's 2013 Donor Advised Fund Report

Here are common traps to avoid:

There Is No Second Deduction

Too many clients think they get a second tax deduction when the charity receives a distribution from the fund, says John Gugle, principal of Alpha Financial Advisors in Charlotte, N.C.

"We have to explain over and over again that their tax deduction stems from their initial donation to the donor-advised fund," Mr. Gugle says. Clients also may need reminding that there can be a variance between what they contributed to the fund and what was paid out to their charity due to market fluctuations, he says.

Charity May Not Be Approved

Some donors get tripped up by assuming their fund will allow them to donate to any charity they choose. In reality, donor-advised funds must approve a charity before any transfer is made. While larger charities such as universities are likely already approved, smaller charities might not be.

"To be extra safe, make sure your charities are approved by the donor-advised fund before making the donation to the fund," says Mr. Altfest.

If the smaller charities aren't approved, ask the fund's managers to get them on the approved list.

Don't Accept Goods or Services

The biggest mistake financial planner Rand Spero sees is when clients want something in exchange for their charitable contributions. Donor-advised funds insist that any donation is made with the understanding that no goods or services were received for the gift, says Mr. Spero, president of Street Smart Financial in Lexington, Mass. That's a problem for a client who, say, wants to use money from his fund to buy a vacation rental through a charitable auction.

Unused Funds Go to Waste

Financial planner Mark Coffey has seen some clients create donor-advised funds without having any true charitable intent. The assets just sit in the fund without supporting any charity.

"In situations where a client funds such an account in order to partially offset a taxable windfall, I've found that their funds will languish each year because they never developed a strategic charitable-gifting approach," says Mr. Coffey, a senior financial adviser at Summit Financial Strategies in Columbus, Ohio.

Mr. Coffey says he works with such clients developing strategic giving plans or investing the money profitably until they develop their own strategy.

Don't Break Your Budget

Donor-advised funds can help clients take bigger charitable deductions in some years than they might be able to otherwise, says Mr. Altfest. However, some clients can overestimate how generous they can afford to be. Problems can arise if the client experiences a cash pinch, because all money placed in donor-advised funds is irrevocable.

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