



ISSUE PAPER

# Simplify the Excise Tax on Private Foundations (S. 676 / H.R.4090)

**Position:** The Council on Foundations supports simplification of the private foundation excise tax on net investment income to a flat rate that is revenue neutral.

## U.S. Senate Bill S. 676

*Lead Sponsors:*

Charles Schumer (D-NY)  
Richard Burr (R-NC)  
Debbie Stabenow (D-MI)  
Carl Levin (D-MI)

*Cosponsors:*

Mark Begich (D-AK)  
Saxby Chambliss (R-GA)  
Johnny Isakson (R-GA)  
Lisa Murkowski (R-AK)

## U.S. House of Representatives Bill H.R. 4090

*Lead Sponsors:*

Danny K. Davis (D-IL7)  
John Lewis (D-GA5)  
Patrick J. Tiberi (R-OH12)

*Co-sponsors:*

Sander Levin (D-MI)	John Spratt (D-SC)
Tom Cole (R-OK)	Fred Upton (R-MI6)
Don Young (R-AK)	Jesse Jackson, Jr. (D-IL)
Bob Etheridge (D-NC)	Nick Rahall (D-WV)
Dale Kildee (D-MI)	Sanford Bishop (D-GA)
Tim Murphy (R-PA)	Mark Schauer (D-MI)
Gary Peters (D-MI)	Keith Ellison (D-MN)
Hank Johnson (D-GA)	Rush Holt (D-NJ)
Luis Gutierrez (D-IL)	

## Revenue Estimate

Revenue Neutral

## Current Law

Internal Revenue Code section 4940 requires private foundations to pay an annual excise tax equal to 2 percent of their net investment income. However, the tax is reduced to 1 percent in any year in which a foundation’s distributions (measured as a percentage of assets) exceeds the average payout rate of the foundation calculated over the preceding five years. Not only must the current distribution percentage exceed the previous five-year average, but it must do so by an amount at least as much as the 1% tax savings the foundation will enjoy. This “maintenance of effort test” was intended to ensure that the tax savings be used for additional charitable expenditures and not just “pocketed” by the foundation. Congress stated upon enactment of the excise tax that it was meant to fund IRS operations relating to the non-profit sector. Whether or not a foundation qualifies for the 1% reduction, it is still required to make annual minimum distributions (equal to approximately 5% of assets) under Code section 4942.

## Proposal

Simplify the excise tax on investment income by eliminating the current two-tiered rate and replacing it with a flat revenue-neutral rate, which the Joint Committee on Taxation estimates to be 1.39 percent.

## Rationale

**Disincentive Effect:** The current two-tier system actually serves as a disincentive to increased giving, especially in times of crisis or economic turmoil. A 2006 study by Professors Richard Sansing of Dartmouth and Robert Yetman of the University of California found that current law can have “countervailing effects on foundation behavior.” The study noted that current law “creates a tax-induced incentive” to reduce contributions in “difficult economic times” such as we are now experiencing “because a high distribution this year makes it more difficult to qualify for the lower rate during the next 5 years.” That is particularly true if, as in the recent past, asset values have declined sharply, thus reducing the denominator by which payout rates are calculated. In such instances, foundations subject themselves to higher tax rates in future years unless they also reduce the dollar amount of their giving at a time when such support is most needed.

**Penalizing Extraordinary Giving:** Any increase in annual giving, relative to the foundation’s assets, will necessarily increase the five-year average payout. Significant increased giving can occur when a foundation seeks to respond to an extraordinary event, such as Hurricane Katrina, the September 11<sup>th</sup> attacks, or another crisis. An increase in giving relative to endowment can also occur where grantmaking remains stable, but endowment values decline. Many private foundations in America are seeking to maintain, or increase, prior grant commitments even at times of sharp drops in endowment values. However, honoring those commitments cause their payout rates to increase, and penalize them with higher taxes when their grants return to more sustainable levels.

**Simplification:** A flat excise tax rate will simplify tax planning for many foundations, especially smaller foundations. The calculation of distributions necessary to qualify for the reduced tax is a moving target because it depends on the 12-month average asset balance of the foundation, which cannot be known until the end of the year, and on the foundation’s investment income, which may not be fully known until well into the following year. Foundations must base their annual budget on assumptions about the market and community needs, which can change dramatically. Foundations spend considerable time and money every year ensuring the amount spent by the end of year is neither too high nor too low, thus allocating valuable resources to accountants and lawyers rather than grantees.

**Tax Policy:** The Council has long supported reduction or elimination of the section 4940 tax because it has never been used as it was originally intended—to pay for IRS enforcement and oversight of the nonprofit sector. In fact, each year the government receives substantially more from the excise tax than it spends for that intended purpose.

## **S. 676 / H.R. 4090**

On March 24, 2009, Senators Charles Schumer (D-NY), Debbie Stabenow (D-MI), and Carl Levin (D-MI), joined the following day by Senator Richard Burr (R-NC) and other Republicans, introduced S. 676, which would amend the Internal Revenue Code of 1986 to remove the current two-tiered excise tax imposed on private foundations and replace it with a single flat rate believed to be set at a revenue neutral level. That legislation now has a total of seven Senate cosponsors.

On November 17, 2009, Representative Danny Davis (D-IL07), along with Representatives John Lewis (D-GA05) and Patrick Tiberi (R-OH12), introduced a House companion excise tax bill, HR. 4090. That proposal similarly would establish a single, revenue neutral rate, but would do so for a temporary period of five years to allow a careful study of the effects of a single rate upon foundation giving. H.R. 4090 currently has 18 cosponsors, including Representative Sander Levin (D-MI12), who has since become Acting Chairman of the Ways and Means Committee, and Representative John Spratt (D-SC05), Chairman of the House Budget Committee.

### **Revenue Neutrality**

Both S. 676 and H.R. 4090 would impose a single excise tax rate at a level meant to achieve revenue neutrality. Though the bills, as introduced, specified a rate of 1.32%, which the bills' sponsors believed approximated a revenue neutral rate, the bills' sponsors support enactment of legislation specifying a 1.39% rate, which conforms to the subsequent Joint Committee on Taxation estimate of what would constitute a revenue neutral rate.

Though foundations would welcome a flat rate of 1%, they recognize that fiscal realities make problematic any tax code change which would result in a loss of revenue. For that reason, and because the principal problems presented by the current two-tiered excise tax rate do not relate to revenue, the Council on Foundations supports a single, revenue neutral rate of 1.39%.

### **Other Policy Considerations**

The proposal to simplify the excise tax on private foundations enjoys wide support within the philanthropic community, and is advocated by the Council on Foundations, an association of some 2,000 foundations and corporate giving programs and a voice of philanthropy at the national level. However, views among the philanthropic community are not monolithic. Some foundations are able to successfully manage their distributions in order to qualify for the 1% rate year after year. For those foundations, any rate above 1 percent will be a tax increase. Though all foundations acknowledge the problems of current law, and all foundations would benefit from the administrative savings resulting from a single rate, not all favor a change in the law which could increase their particular tax liabilities. Also, some Congressional staff have expressed their belief that the current two-tiered rate structure incentivizes increased giving above and beyond the minimum distribution required by law. While supportive of the idea of simplification, they believe any proposal to amend the structure should retain incentives for foundations to annually increase their giving.