



ISSUE PAPER

Simplify the Excise Tax on Private Foundations (S. 593/ H.R. 2311)

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

S. 593

Sponsor: Charles Schumer (D-NY)

Co-Sponsors:

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H.R. 2311

Sponsors:

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- Danny Davis (D-IL07)

Co-Sponsors

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Revenue Estimate

Revenue Neutral at 1.39%
Ten-year Revenue Loss of \$54 million at 1.35%
(Administration Proposal)

Current Law

Each year, private foundations are required to pay an annual excise tax equal to 2 percent of their net investment income¹. If a foundation's distributions (measured as a percentage of assets) in a given year exceeds the average payout rate of the foundation over the preceding five years—by an amount at least as much as the 1 percent tax savings the foundation will enjoy—then this tax is reduced to 1 percent¹. 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. By Congressional directive, revenues from the excise tax are meant to fund IRS oversight of the non-profit sector.

Proposal

In 2011, Senate and House legislative proposals were introduced that would amend the Internal Revenue Code of 1986 to modify and simplify the excise tax on the investment income that private foundations pay¹, by removing the current two-tiered excise tax imposed on private foundations and replacing it with one flat rate. The proposals set this flat rate at 1.39 percent—deemed to be revenue neutral by the Joint Committee on Taxation in the 111th Congress—and would apply to tax years beginning after the date the bill is enacted.

Rationale

Disincentive Effect: The current two-tier system serves as a disincentive to increased giving, especially in times of crisis or economic turmoil (“The Katrina Effect”). 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.” It also 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: Under the current tax law, 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 11th attacks, during tough economic times or another crisis. An increase in giving relative to endowment can also occur where grantmaking remains stable, but endowment values decline. Many private foundations are seeking to maintain, or increase, prior grant commitments during these difficult times. Honoring those commitments causes payout rates on private foundations to increase, and penalizes them with higher taxes when their grants return to more sustainable levels.

Simplification: A flat excise tax rate will simplify tax planning, especially for smaller foundations, who may lack resources for complex financial planning. 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 current version of the excise 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.

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 1,700 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 percent rate year after year. For those foundations, any rate above 1 percent will be a tax increase. Though foundations acknowledge the problems of current law—and all foundations would benefit from the administrative savings resulting from a single rate—not all enthusiastically 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.

Obama FY2013 Budget Proposal Includes a Simplified Excise Tax for Private Foundations

On February 13, 2012 the Obama Administration's released its fiscal year 2013 budget proposal. The budget includes a provision calling for a single, 1.35 percent excise-tax rate on investment income of private foundations. The Administration estimates that permanently setting the rate at 1.35 percent would result in a revenue loss of \$54 million over ten years. The lower rate is apparently sufficiently more efficient for the Treasury Department to administer to justify the minor revenue loss. The Council supports increased efficiency at all levels of government and therefore is unopposed to lowering the rate to achieve administrative savings by the government.

How Can You Support Philanthropy:

Please co-sponsor S. 593 and H.R. 2311, respectively which would amend the Internal Revenue Code of 1986 to modify and simplify the excise tax on the investment income that private foundations pay. S.593 and H.R. 2311 would remove the current two-tiered excise tax imposed on private foundations and replace it with one flat rate of 1.39 percent.

For more information, contact the Council
Government Relations Department at:
(703) 879-0600 or govt@cof.org