

CRS Report for Congress

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Minimum Distribution Requirements for Foundations: Proposal to Disallow Administrative Costs

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Summary

Legislation introduced in the House (H.R. 7) to provide tax incentives for charitable giving includes provisions disallowing the counting of administrative costs as part of a minimum distribution requirement for private foundations. The issue of administrative costs and minimum distributions has been the subject of a series of changes in the past, but currently there are no restrictions other than that administrative expenses be reasonable. The principal arguments for adopting the provision are to discourage excessive administrative costs and increase the level of grants. The principal objections are that the restriction would increase the tendency of current requirements to erode real asset values and that the restriction would be especially harmful for those grant objectives that require a significant amount of monitoring.

The Senate has passed legislation, S. 476, that provides for a series of tax benefits designed to encourage charitable contributions. The House had passed its own version of this legislation in the 107th Congress, H.R. 7. The House-passed version included a provision beneficial to private foundations, which would reduce a small excise tax applied to investment earnings; this issue was not addressed in the Senate bill.¹ The current version of H.R. 7, introduced by Congressman Blunt, added a provision to the bill to disallow the counting of administrative costs in determining the minimum distribution costs of private foundations that make grants. This report explains the current minimum distribution requirements in the tax law and the history of this provision, and discusses the issues. A planned markup of the bill by the Ways and Means Committee on September 4 has been postponed to consider this provision further.

Current Tax Treatment of Private Foundations

¹ See CRS Report RS21144, *Tax Incentives for Charity: An Overview of Legislative Proposals*, by Jane G. Gravelle for an overview of the provisions in these bills.

A donor who sets up the foundation can benefit from tax deductions for the contribution, without immediately making the charitable donation. Rather, the foundation can retain assets and make contributions over time; the founder or his heirs can retain control over the distribution of funds. Investment earnings are not subject to income taxes. The tax law imposes some restrictions, therefore, on foundations to ensure that the charitable purpose is realized and that the benefits do not accrue to private parties. Among these restrictions is a requirement that 5% of investment assets be distributed each year in a qualifying distribution. If this distribution is not achieved, there is an excise tax of 15% in the first year, which then becomes 100% if the distribution is not made in the second year. Thus, because this tax is confiscatory, foundations must effectively distribute the 5% amount.

The proposed change in H.R. 7 would not allow administrative costs to count against the minimum distribution requirement for foundations that make grant (technically called non-operating foundations).

Legislative History

The excise taxes and regulations applicable to foundations reflect a concern that the tax benefits not be used to provide private benefits and that the charitable purpose be served by preventing the accumulation of assets in the foundation. Many of these provisions, including the minimum distribution requirement, were originally adopted in the Tax Reform Act of 1969. Part of the reason for the minimum distribution rule was to replace an existing system where foundations could lose their exempt status if they had excessive accumulations, a cumbersome and difficult system which often involved expensive litigation. The two tax-writing committees initially reported a 5% minimum, but that number was raised to 6% on the Senate floor; the figure could be adjusted by the Treasury based on investment yields. The provision also required a distribution of all net income if that amount were larger.

This restriction was followed by two reductions of the distribution requirement. First, the minimum distribution (which had become 6.75% by 1976) was lowered to 5% and fixed at that level by the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 eliminated the requirement that all net income be paid out if that amount were larger. The reason given for this 1981 change was that payment of all income would gradually erode the value of the real assets because of inflation, a problem that had become much more severe over time.

The Deficit Reduction Act of 1984 temporarily limited administrative expenses that could be included in the minimum distribution rule to 0.65% of assets and the requirement that administrative expenses be reasonable and necessary was put into the statute (it was already in the regulations). This restriction reflected a concern that much or all of the distribution requirement could be met by administrative expenses, and that the public purpose of the charitable treatment was to provide the actual charitable benefits. This limit was to expire at the end of 1990 and a Treasury report mandated by the legislation recommended in 1990 that the termination occur (and it did).

Issues

Many of the arguments for excluding administrative costs from the payout requirement are presented in a study by the National Committee on Responsible Philanthropy². The principal arguments in these studies, which also present data on the administrative expenses of foundations, are that the restriction would encourage foundations to be frugal in their administrative overhead and would make available an additional amount of charitable donations from foundations, of up to \$3.2 billion in 2003. The reports also suggest that such a restriction is quite manageable, as foundation administrative costs average only 8.7% of distributions or 0.4% of assets, and that, based on historical evidence on earnings, these amounts could be covered without reducing the size of foundations. The reports also indicate a concern for excessive administrative costs, particularly in the form of high salaries of officers, citing some examples. The studies also point out, in response to criticisms that the higher payouts will reduce that value of foundations assets, that private foundations receive funds from other sources than earnings on assets, including ongoing donations by families.

Foundations critical of this change have made two basic arguments. First, they dispute the argument above that foundations will be able to make larger payouts without eroding the value of assets. Indeed, they argue that even the current 5% payout requirement inclusive of administrative costs would eventually erode real asset value (accounting for inflation), given historical nominal returns. They also argue that the provision would discourage grants to smaller, grass-roots groups that require more administrative attention and entail higher costs to monitor and support recipients. In addition to these arguments, they also suggest that news stories reporting abuses by foundations, in particular in the form of excessive salaries relative to grants, are not representative.³

Historical data suggest that real earnings could exceed the 5% or 5.5% level if the portfolio contains significant risky assets (such as corporate stock), but probably not with relatively riskless assets. During the period 1959-2001, the average return on 6-month Treasury bills was 1.7%; the return on Baa corporate bonds was 3.5%. Real returns varied substantially over time, with returns quite low in the 1970s, but relatively high in the 1980s and 1990s. (Baa bonds earned real returns in excess of 5.5% in every year from 1981 on, however). Corporate stock has typically (over a long period of time) returned real earnings of 7% or more, but earnings can fluctuate even more over time.

However, even if the average foundation could not consistently earn the required amount to retain real assets, there is also a public policy question of whether it is important to preserve the real value of foundation assets in perpetuity absent any

² “Helping Charities, Sustaining Foundations,” June 2, 2003, and “A Billion Here, A Billion There: The Empirical Data Add Up,” July 8, 2003. As of this writing, these reports are posted on the web at <http://www.ncrp.org/>. The second report was a response to criticisms by the Council of Foundations, discussed below.

³ A “talking points” fact sheet and rebuttal to the first study of the National Committee on Responsible Philanthropy, discussed above, was issued by the Council on Foundations in June 2003. As of this writing it can be found at <http://www.cof.org/>, the Council’s website, along with other materials addressing these issues.

additional contributions. From the standpoint of the charitable objective, payout requirements are really about the timing of charitable bequests, and it might be desirable to pay out amounts earlier rather than later. Moreover, there has always been a concern that foundations are ways of avoiding income and estate taxes while preserving the power that comes with control over assets. On the other hand, increased restrictions on foundations may also make them less attractive and reduce charitable giving in the long run.

Possible Revisions

One method of restricting administrative expenses without increasing total distribution requirements for foundations with modest administrative costs is the separate restriction on these costs as adopted in 1984. News reports also suggest that one possible revision might be to disallow only certain types of expenses (e.g., salaries above a certain level, other items deemed to be “luxury” ones). At the end of July, Senator Hutchinson introduced a bill, S. 1514 which, among other provisions, would disallow expenses such as foreign travel and first-class air travel.