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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 Ways and Means Committee has modified this provision in reporting out the bill by restricting the types of administrative costs eligible. H.R. 7 was passed by the House on September 17, 2003. 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 disallowing administrative costs in the minimum distribution requirement 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 revision may deal in part with that last objection.

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 version of H.R. 7, introduced by Congressman Blunt in the 108th Congress, added a provision to the bill to disallow the counting of administrative costs in determining the distributions of private foundations that make grants. A planned markup of the bill by the Ways and Means Committee on September 4, 2003 had been postponed to consider this provision further. The Ways and Means Committee in reporting out the bill on September 9 allowed administrative costs to be counted in distributions for purposes of the minimum

¹ See CRS Report RS21144, *Tax Incentives for Charity: An Overview of Legislative Proposals*, by (name redacted) for an overview of the provisions in these bills.

distribution requirement, but restricted the amounts. Eligible administrative costs must be directly related to the charitable purpose, grant monitoring and administration, and costs related to compliance with the law and public accountability. Salaries paid to “disqualified persons “ (generally top management, contributors and related persons) in excess of \$100,000, non-commercial air transportation and commercial air transportation in excess of coach class accommodations are not eligible. At the end of July, Senator Hutchinson introduced a bill, S. 1514 which was similar but not identical to the Ways and Means proposal; in the case of travel provisions, it would also disallow expenses for foreign travel.

H.R. 7 was passed by the House on September 17, 2003.

This report explains the current minimum distribution requirements in the tax law and the history of this provision, and discusses the issues. Charitable contributions legislation is likely to recur in the 109th Congress, although the current Senate bill, S. 6, does not address this issue.

Current Tax Treatment of Private Foundations

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 suggests 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

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.

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 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.

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; this approach would be less restrictive than disallowing administrative costs but could more greatly constrain foundations with high grant monitoring costs. The alternative of disallowing only certain types of expenses (e.g., salaries above a certain level, other items deemed to be “luxury” ones) may have the effect of limiting the exclusion of administrative costs for a different type of foundation that has highly compensated management (and large foundations would typically require highly compensated management expertise). But these costs may not be a significant part of the overall administrative cost.

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.

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