

Philanthropic Foundations: Payout and Related Public Policy Issues

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Both proponents and opponents of changes in the laws, regulations, and practices of charitable foundations have the same goal: enhancing public well-being through the best use of charitable resources. In the language of investment, that goal implies maximizing the social return on those assets. Measuring the social return on different types of activities and comparing outcomes or even outputs over time, however, is not so easy. Moreover, the issue of how to treat existing foundation assets and activities cannot be separated from the broader issue of the development of the charitable sector as a whole, including the establishment of new foundations and other endowed funds over time. Thus, it is not surprising that there is no unanimity on whether or how foundations should change their behavior or, more narrowly, on what new laws should apply to foundations and the amounts they are required to distribute for their charitable purposes. Still, many serious proposals have been forthcoming in recent months and years. Against this backdrop, a group of nonprofit leaders, government officials, journalists, researchers, and legal experts met at the Urban Institute in Washington, D.C., in September 2003 to discuss proposals to regulate charitable foundations. This was the 10th Emerging Issues Seminar cosponsored by the Urban Institute's Center on Nonprofits and Philanthropy and Harvard University's Hauser Center for Nonprofit Organizations.

Types of Legislative Proposals

Recent legislative proposals have focused on three areas:

- Simplifying and reducing the excise tax on foundations;
- Increasing current charitable activity by raising the minimum 5 percent payout level; and
- Legislating caps on certain kinds of administrative expenses or omitting administrative expenses (e.g., executive salaries, trustee fees, and staff travel) that can be counted toward the payout.

The first question the group addressed was "Why?" Why are these legislative proposals being put forward? Do they have a common purpose? Are there other ways to accomplish the same objectives? Some seminar participants viewed these proposals as responses to inadequate enforcement for that small subset of the charitable sector that engaged in questionable activity. According to this view, the current regulatory framework, including the mandated yearly 5 percent payout to charities, would be sufficient—if it were adequately enforced.

Much discussion centered on maximizing charitable output in the short term versus the long term. One argument contends that a lower current payout (through a lower payout rate or allowing administrative expenses to count as payout) maximizes charitable giving over the long term, because it permits foundations to sustain and grow their endowments. An opposing argument is that the value to society of contributions made by foundations is greater today than in the future. In many ways, this dispute is over the time-value of money and how to discount the payments made in the future relative to today.

Compounding the difficulty of making this comparison is that returns accrue tax-free within the foundation, but private indi-

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viduals accrue income on an after-tax basis. If the individual discount rate is equal to the after-tax rate (that is, the rate at which individuals must choose between consumption for today versus the future), then, as a factual matter, money left in foundations is allowed to accrue at an even higher rate because it avoids taxes. At first, this differential might appear to justify maximizing the amount left to accrue in foundations, where it might achieve, for example, a 6 percent return when individuals were indifferent between \$1.04 tomorrow versus \$1.00 today. If one follows this argument to its extreme, then no payout should be made currently because, at that discount rate, the \$1.06 of (charitable) consumption tomorrow is presumably worth more than \$1.00 today. But in fact, such comparison dodges the main issue. The individual as taxpayer makes up the difference. That is, when foundations accrue income tax-free, the individual must pay higher taxes or give up the expenditures that government could otherwise provide.¹

Reasonable people disagree on the relative value of foundation grants today versus the future for other reasons as well. For example, if people are wealthier tomorrow, then one can ask whether it is worthwhile delaying charitable activity to serve them rather than those who are poorer today. This argument follows a utilitarian notion (again unproven but well-accepted) that a dollar for someone who is poorer is more valuable than a dollar for someone who is richer. However, while one person's consumption today might be compared with that same person's consumption tomorrow using a discount rate (that is, at a given interest rate each person can make a personal judgment on how much to sacrifice today to achieve more consumption tomorrow), there is no pure theoretical way to compare the value of charity for one person today with that of another person tomorrow.

Moreover, some foundation expenditures operate more like investment than consumption. For example, both current and future generations would be better off if a foundation spent capital on a successful cure for AIDS.

These issues are not unique to foundations, but affect other types of endowments, such as those of colleges, hospitals, and other nonprofits. Here also the issue arises of how to balance the claimants and needs

of today against those of the future. How do we value sacrifices of society today to compound benefits for future generations? Should different rules apply to foundation endowments than to other endowments? While participants had different views on whether society had achieved a satisfactory balance, or even whether any rule on non-foundation endowments could be enforceable, they recognized the large stake society had in answering the question satisfactorily.

The Excise Tax on Foundations. The one clear-cut area of agreement among participants was that the excise tax on foundation income should be simplified and reduced. That excise tax, at either 1 or 2 percent of income, encourages foundations to minimize giving—increased giving in one year could lead to a higher base for determining whether giving had remained the same or increased over time.² The existing excise tax imposes the higher 2 percent rate when giving is not sustained at the higher base. Also, the excise tax adds significantly to complexity in filing forms, and, for some, in planning. Legislative history indicates that one justification for the tax was to help pay for Internal Revenue Service (IRS) oversight of foundations and, more broadly, of the charitable sector. Participants wanted that oversight, but it was not forthcoming from an IRS too strapped to perform its many functions.

A lower excise tax, of course, would mean more for charitable activity, whether today or tomorrow. There was not perfect agreement, however, on whether the excise tax should be devoted solely to regulatory oversight of the charitable sector. Although most participants felt that IRS regulatory efforts should be expanded, earmarking excise taxes sets a rather precise standard for what should be spent. There was no evidence that the amount determined by an arbitrary tax rate would be precisely the correct amount to be spent, given other societal needs and IRS enforcement responsibilities.

The Foundation Payout Rate: Individual Foundations versus Charitable Wealth as a Whole. Regardless of the rate applied by society in valuing foundation grants tomorrow versus today, a few people felt that behind some of the proposed changes are concerns over the power, size, and longevity of private foundations. A higher payout could be one means of

restraining that power. One person suggested that perpetuity of individual foundations may not be in society's best interest. Research, some noted, showed that foundations that pay out a minimum of 5 percent have growing endowments and have been permitted to increase their relative hold on society. A related but shorter-term focus was that foundations had amassed significant wealth in the stock market run-up (despite recent losses) and could afford to share those gains with nonprofit organizations experiencing financial distress while state and federal budgets and charitable giving are declining. These participants cited studies showing that foundations could sustain a higher payout.

In the end, however, a now-familiar issue reared its head. Is it worthwhile to delay some giving today so more can be done tomorrow? For those arguing for a higher payout, the value of charitable activity today is greater than it will be tomorrow, so they urge increasing grantmaking now in place of allowing endowments to grow or at least sustain themselves.

Some balance is required. Maximizing charitable output tomorrow would imply zero payout today, while maximizing charitable output today would imply 100 percent payout now. Compromise is needed to maintain an influential, yet not ever-more-powerful, foundation sector. There is a difference, however, between the sector's power and influence and that of individual foundations. New foundations continue to be created, and the sector itself could grow even if existing foundations were required to make payouts that gradually reduced their relative or real wealth. Many participants felt the current 5 percent payout rate was a reasonable compromise; others felt the rate could be increased. Interestingly, no one really argued for reducing it.

Perhaps the size of foundation assets compared with the economy or the charitable sector as a whole is an appropriate yardstick for ensuring that individual institutions do not continually increase their relative power and status over time. At least some measures like this provide a way to think about how to set the minimum payout rate. The history behind the 5 percent standard reflects a view that it represents the long-term real rate of return foundations are likely to achieve. If that estimate

is correct, then each foundation is already limited in its real growth and relative status in a growing economy.

A closely related issue addressed at the session was how to ensure that what foundations do is in society's best interest. Donors' wishes may represent the best "market" test available for determining what foundations should do. If so, older foundations might be viewed as straying further and further from those wishes. But are donors' wishes the best arbiter of society's best interests? Some felt the growing use of professionals meant that foundations were becoming better at measuring society's needs over time, rather than simply responding to the current whims of the donor. One participant suggested that getting the highest quality output from foundations requires more than simply optimizing the payout rate. Foundation boards, for example, could be made more representative of the public, and loopholes in the current self-dealing regulations could be closed. Expressed this way, the issue at hand is less one of restricting the power of either foundations or original donors but, instead, of ensuring that foundations have mechanisms to help rechannel and redirect their efforts as society's needs evolve.

Payouts Adjusted for Economic Cycles. A separate question, often hidden in the debate over payout, is whether payouts can be adjusted, regardless of their average size over time, so that grants are made countercyclically. Such a rule would encourage foundations to pay out more when the economy is in a down-cycle, while replenishing endowments during good economic times. One participant suggested that this area received inadequate attention, and several participants agreed.

Statutory Provisions Related to Administrative Expenses

Limiting wasteful or excessive expenditures is another goal of those proposing legal or regulatory change. Defining "wasteful" or "excessive," however, is not easy. The diversity of foundations and the programs they undertake makes it difficult to make a one-size-fits-all determination. The current yardstick is that "reasonable and necessary" expenditures are permitted. Participants questioned whether that yard-

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stick (also used in corporate regulation) adds legal pressure to control administrative expenses. It is also a concept, noted several participants, that does not lend itself to efficient oversight by the IRS without further elaboration.

Several participants questioned efforts to limit administrative expenses in an era of good governance that stresses effective grant-making and measurable outcomes—goals that require staff and administrative investments. At times, the goals of effectiveness and efficiency seem to conflict. Costs, such as staffing to communicate with grantees, rise when foundations seek outcome measures and evaluations. A limitation on administrative expenses was imposed in 1984; analyses showed that little was accomplished other than more complex reporting, so the provision was allowed to sunset.

One person questioned whether the “reasonable and necessary” requirement creates pressure to control administrative expenses. If we decide to legislate a numerical limit for an acceptable level of administrative expenses, how are we going to determine that number and how can it be enforced with self-reported data? To that point, one participant voiced a fear of unintended consequences: that a number, like a proposed \$100,000 ceiling on executive salaries, also becomes a floor that might not be reasonable for all foundations.

Several participants voiced concern that the proposed legislation is largely symbolic and very vague, and will prove difficult to enforce. If Congress were to hold hearings in five years, what could the IRS document to show that there were fewer abuses or that these abuses were more or less widespread than originally thought?

Discussion turned to how expenses vary by size or type of foundations. One participant asked whether all small foundations, which seem particularly susceptible to abuse, would be required to become donor-advised funds. Of course, many small foundations subsequently become large, and we really do not know the extent of abuse in small foundations. The diversity of foundations, large and small, organized for many different purposes has served society well, opined one participant. Until we have data to the contrary, the benefits of allowing seemingly higher expense ratios seem to outweigh the drawbacks.

A more targeted attempt to control administrative expenses relates to the recent

news stories on the salaries and trustee fees of some foundations. Some felt that excessive salaries, and perhaps trustee fees, should be outlawed or not permitted to count toward the charitable payout. A contrary argument was that banks often are trustees, and it is quite difficult to separate banking fees from trustee fees. Certainly there is a question of reasonable fiduciary responsibility here, whether moral, legal, or both.

There is virtually no public accountability and no data on donor-advised funds and little oversight of the rapidly growing small foundations or donor-advised funds, observed one participant. For those donor-advised funds without staff, blanket rules for small endowments probably will not work. In the opinion of one participant, there is no need for additional regulations to stem abuses; what we need is enforcement of the regulations on the books.

Enforcement of Regulations

Enforcement concerned many seminar participants. After the Tax Reform Act of 1969, foundations were audited regularly. The audit rate had fallen over the past 20 years, along with the IRS’s budget. Originally, the excise tax on foundations was supposed to be dedicated to enforcement and oversight of foundations and other exempt organizations, but those collections were never made explicitly available to the IRS. One participant suggested legislation to mandate that the foundation excise tax at least provide enough resources to maintain the databases necessary for oversight. Currently, some efforts (such as the National Center for Charitable Statistics [NCCS] and GuideStar databases), are funded through philanthropy, but only so much can be expected from foundations.

State regulation of foundations, especially small foundations without living donors, is also minimal, noted several participants. And to compound the problem, state regulators can share information with the IRS, but the IRS believes it cannot share audit information with the states unless and until revocation of exemption occurs. The Senate’s proposed legislation would allow the IRS to provide information to the states and coordinate investigations.

Given the dismal state of oversight, one participant wondered, is there any reason to expect more regulation to produce better results? One ray of hope is the recent roll-

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out of electronic filing of the annual public reports to the IRS (Forms 990 and 990-PF), an effort facilitated by NCCS and GuideStar. These data could provide tools for both states and the IRS to check the financial reporting of charities and foundations for egregious expenses and mandated payout levels. The data also support a system of public monitoring, which may be more important now than government monitoring.

One participant noted that, with stricter regulation of private foundations, donors would be more likely to do their charitable giving through community foundations, supporting organizations, and commercially sponsored donor-advised funds. These entities are not governed by the private foundation rules. How are we going to ensure those organizations are adequately monitored?

Given the current state of government oversight, one participant asked whether an intermediary organization needs to encourage greater enforcement of regulations. Joel Fleishman's proposal for a U.S. Charities Regulatory Commission was cited. Funding such an entity may be a barrier. A participant asked whether there is a way to "sell" improved monitoring. In the opinion of one former regulator, until people believe they can be caught, no potential penalty, no matter how high, will change behavior. Thus, legislation alone will not shape behavior.

Another suggestion was a user fee on each application for exempt status or filing of Forms 990 and 990-PF. These fees could provide the IRS with millions of dollars a year to use for enforcement, oversight, and data preparation. There are precedents in government for such a step, and reliance on fees would bypass the appropriation cycle and create a stable source of ongoing funding. This step could be achieved with a statutory change.

What the Data Suggest

One participant said that we are in the "dark ages" when it comes to data on foundations. Unless the government steps in and supports data gathering and analysis, decision-makers are creating policy in an information vacuum. Current data on foundations allow only limited study of foundation payouts and administrative expenses. What is needed is a sample of foundations followed over time (six years was suggested), so we

can understand the variability of expenses. We need to better understand the unanticipated consequences of the foundation excise tax, which seem to have induced large foundations to keep payout near the 5 percent level. We also need better analysis of the components of administrative expenses: What do foundations include in the "other" expenses category?

Data ideally should be able to account for different foundation purposes and timeframes to assess the appropriateness of their payouts and administrative expenses. Again, on an ideal basis, we need to be looking at the quality of grantmaking, not just the spending rates, said one participant. What is the value of foundations' administrative expenses to the nonprofits they fund? We calculate the effect of rules on foundation resources, one observer commented, but not on resources of the broader nonprofit sector.

Moreover, information on the current Form 990-PF foundation report is not adequate to catch many forms of self-dealing, conflicts of interest, and costs of board meetings and travel, charged one participant. Finally, the quality of self-reporting can be poor: One participant noted that there is a high level of error on the forms, which argues for making them simpler, not more complex.

At the end of the day, participants viewed the current legislative proposals as a warning signal. Abuses, however few, are costly in dollars lost to the sector and in the sector's reputation, and need to be curbed. There must be a balance between efficiency and effectiveness in grantmaking, and abuse of the public trust must not be tolerated. Remedies must be sought both from within the charitable sector and from government.

Notes

1. This argument for allowing maximum accumulation in charities, by the way, is almost the same as one used to justify a zero tax on capital income (output tomorrow should be valued the same as output today multiplied by a before-tax interest rate). Exempting charities from any current payout, however, is a bit of a backdoor way to try to achieve that objective, even assuming that it was agreed to by society.
2. See C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," *American Journal of Tax Policy* 12, no. 2 (Fall 1995): 399-447. Also published in *The Exempt Organization Tax Review* 13, no. 5 (May 1996): 769-87.



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