

Foundation Payout: Getting Beyond the 5%
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I. Introduction:

As soon as people such as Andrew Carnegie and John D. Rockefeller started creating foundations in the early 1900s to focus on “the advancement of knowledge and human welfare” (Bremner 112), there have been people to criticize and question both the intentions and the impacts of these types of benevolent actions. A great deal of scholarship and discussion has occurred, especially in the last fifty years, specifically dealing with payout requirements, excise taxes on foundation income, and a variety of other issues. Although much of the discussion about abuses of tax exemption and other abuses by charitable foundations and trusts began in the House Committee on Ways and Means in early 1950, by far, the most notable legislation that has been passed in the last fifty years with the most substantial impact on private foundations was the Tax Reform Act of 1969. This new legislation was motivated by a number of factors including Congressman Wright Patman’s eight-year personal crusade to make foundations accountable to the public and a series of controversies during the 1960s surrounding the activities of some of the more prominent foundations (Frumkin 86). This tax legislation was designed and implemented to bring foundations under greater oversight than they had been under in the past. With this piece of legislation, for the first time in the history of foundations, laws were created to mandate payout requirements and excise taxes for private foundations.

Originally, the Tax Reform Act of 1969 in section 4942 regarding payout, required that private foundations make a minimum annual charitable distribution equal to their actual income or 6% of their invested assets,

whichever was greater (Steuerle 1663). Then, in 1976 the rule became that private operating foundations must pay out, in grants or other “qualifying distributions” (which includes the Section 4940 excise tax and reasonable administrative expenses), either all of their earned income for the year or 5 % of the market value of that year’s investment assets, whichever was the larger amount (Freeman 68). Finally, in 1981 with the Economic Recovery Tax Act, a flat 5% payout requirement was set (Eddie 31). Thus, the first substantial tax laws relating to private foundations were first established in 1969 and have remained relatively constant since with a few minor changes along the way.

Currently, it is the 5% payout that is a key topic of research, discussion, and debate. However, it is not my intention in this paper to discuss the merits of the 5% payout rule and whether this is, in fact, the correct percent in order for foundations to maintain their value in real, inflation adjusted dollars nor is it my intention to comment on whether the purpose of foundations is to maintain the value of their corpus so as to exist in perpetuity.

Instead, I will focus on the 5% payout requirement from a slightly different perspective. I will explore what can be legally included as part of the payout and how much of the payout actually reaches the individuals, communities, and causes of which the foundations’ missions speak and to which the funds are directed. There have been a few individuals such as Pablo Eisenberg, Peter Frumkin, and a few others who have criticized foundations on a number of different levels. Yet, there has been little, if anything, written on the specific topic of how much of foundation¹ funding ever reaches mission related causes, how much room there is for abuses by foundations even after the notable Tax Reform Act of 1969, and how effective foundations are in accomplishing their stated missions. The 1969 Act definitely eliminated many abuses by individuals. However, there still seems to be ample room for abuse in the sense that

foundations may not be distributing as much as they could to charitable causes as a result of the way that they are able to account for their 5% payout.

Thus, in this paper I will do a careful examination of Section 4942 of the tax code focusing specifically on the variety of places that foundations are currently using their money in ways that are not optimally beneficial for the organizations they are funding or for society in general. I will first explain and comment on various parts of the literature and tax code that relate to foundation payout issues. Then, I will provide some actual foundation data to show how their funds are actually spent as well as how much of the 5% can be lost in salaries, administrative, and other expenses. Finally, I will propose some suggestions as to how to look at this issue in more depth and possibly create or amend some government policies in order to deal with this issue. I am hoping that the subsequent information and discussion, dealing with the issue of where the 5% payout actually goes, will shed light on the topic in such a way that the debate over the proper payout percent will cease to be the most pressing issue and the issue of where the 5% is going will replace it as the most pressing issue in the foundation field.

II. Section 4942 of the Tax Policy and Related Current Literature

The most relevant portion of the tax policy for the purpose of this paper is Section 4942 which deals specifically with the payout requirement for private foundations. This part of the tax code explicitly, although very complexly, describes how a foundation figures out how much it must distribute, to what its funds can be distributed, a variety of ways it can choose to distribute such funds, and the penalties for failing to follow all of the rules and regulations. After examining certain portions of Section 4942, it becomes obvious that there are a number of different ways for

foundations to account for things that would substantially reduce the amount of funds they distribute to charitable and mission oriented causes.

Section 4942 is the portion of the tax code that “requires private foundations to incur expenses so that their ‘qualifying distributions’ each year equal 5% of their average investment assets” (Eddie 30). This requirement contains two important aspects of the tax code that require further discussion and explanation. First, there is the issue of what counts as a qualifying distribution. Then, there is the equally important and closely related issue of determining the value of the average investment assets from which the 5% will be calculated.

A. Qualifying Distributions Under Section 4942

A qualifying distribution is any funds distributed or spent that count as part of the 5% payout requirement. As it would take too long to include all of the complexities and intricacies in the tax code that function as qualifying distributions, I will try to give a general summary of what can be legally included and then provide a few detailed examples.

Eddie explains that there are three types of qualifying distributions, which are: grants and grant equivalents (including program-related investments and set-asides), all necessary and reasonable administrative expenses, and direct charitable activities (such as annual reports, technical assistance to grantees, and publication of in-house research) (30). The analysis of Section 4942 that Stewart and Bartlett compiled suggest that a “qualifying distribution” is any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more charitable purposes (A-14 and 15). These two characterizations of what count as qualifying distributions appear to be relatively simple.

However, the further analysis that Stewart and Bartlett offer suggest some interesting examples that are worth noting. First, they explain that “it is

not required that the grants are made to organizations exempt under 501(c)(3)” (A-15). That is, grants made to supplement government spending or to lessen the burden of government also function as qualifying distributions. Stewart and Bartlett give the example that a “grant to a political subdivision of a state to purchase a majority interest in an arena and parking garage for the purpose of insuring its preservation as an attractive public facility [is] a qualifying distribution” (A-15). This particular intricate detail and interpretation of Section 4942 of the tax code is a potential cause for great concern. Do we really want foundations to be able to fund sports arenas and parking facilities as part of the 5% of the foundation’s assets going towards charitable and public purposes? Also, this type of allowable distribution appears to further blur the distinction between the government sector and the third sector. It seems ironic, and even wasteful, for an individual to get the benefit of a tax deduction for setting up a foundation that will ultimately distribute part of its income to help fund activities, like parking garages and stadiums, that are often funded with those same tax dollars that the individual originally avoided paying.

One of the more obvious and better covered issues regarding qualifying distributions is the amount of money a foundation spends on its administrative expenses and on the salaries of its employees. In the 1984 Tax Reform Act, Congress attempted to limit the amount of salary and administrative costs that a foundation could use towards its 5% payout requirement. It did this with Section 4942(g)(4) which stated that “the amount of grant administrative expenses which may be taken into account for purposes of meeting the 5% distribution requirement is limited to 0.65% of the net assets of the private foundation.” This was a valiant effort on the part of Congress to limit a foundation’s flexibility in spending lavishly on things such as furniture, computers, salaries, etc. However, in Congress’s brief moment of wisdom, it chose to include that

this provision “shall not apply to taxable years beginning after December 31, 1990” (Section 4942(g)(4)). Thus, this particular provision has phased out as of January 1, 1991 leaving much room open for foundations to spend more and give less.

There has been some research conducted and articles written about the amount of a foundation’s 5% payout that goes towards salaries and administrative costs. One of Peter Frumkin’s main findings is that in the six years following the Tax Reform Act of 1969, “average administrative foundation expenses as a percent of grant outlays increased from 6.4% to 14.9%” and “over the past 20 years expenses as a percentage of grant outlays have continued to hover between 15 and 18 percent among large foundations” (Frumkin 88). For my analysis, what is even more important than the administrative expenses as a percent of grants given is the actual part of the 5% payout that is going towards these expenses instead of towards making grants intended for the public good. Pablo Eisenberg, who is a huge proponent of raising the 5% payout, and Stacy Abrams write that “since the definition of the payout includes administrative costs and staff operations, the largest foundations are actually paying out 3.8 to 4 percent of their assets in grants” (81). Frumkin compiled 1995 data from the 20 largest foundations, at the time, and calculated giving as a percent of total foundation assets in order to show how much of the 5% payout requirement actually goes towards funding mission driven activities and how much is spent on sustaining the foundation and its employees. (See Exhibit A). Of these 20 foundations, only 3 of them actually give 5% or more in grants, 9 give in the 4% range, 7 in the 3% range, and one only gave 2.38% of total assets in grants.

Clearly, what is much more important than the percent of assets (and their corresponding dollar amounts) going to grants is how effective those grants are in working towards the foundation’s mission and to what extent the grants have a positive and measurable societal impact. However, since

“there has been no comprehensive study documenting foundation practices or the effectiveness of foundation giving” (Porter and Kramer 127), and despite the fact that the percentage may not be very meaningful, when one adds up the dollar amount that these percentages represent, the numbers say a great deal. (See Exhibit B)

According to my calculations, had these 20 foundations in 1995 given a full 5% to charitable purposes, an additional \$419,383,737.35 would have gone towards these foundations’ mission oriented causes. Or, had the 0.65% maximum allowable spending on salaries and administrative costs from the 1984 Tax Reform Act still been in effect, and additional \$177,580,521.55 would have gone towards charitable endeavors. This money means nothing if it is not used to “create real value for society” (Porter and Kramer 122). Yet, with many struggling and under-funded non-profit organizations, these dollars, if used well, could have some significant, positive impacts on the non-profit sector, on the sector’s beneficiaries, and on society in general. Also, I want to emphasize that Frumkin’s numbers, from which I calculated these figures, are from 1995. With the recent and substantial stock market boom, and the resulting growth of the value of foundations, the roughly \$419 million I calculated as dollars that may not be being spent as well as they could be may now amount to \$1 billion or more. This potential loss or misuse of \$1 billion dollars is a significant amount of resources on which much more attention should be focused.

For example, examining the Richard K. Mellon Foundation, in particular, raises some specific questions. This foundation has a staff of only 3, non-grant expenditures of over 9 million dollars, and has grant distributions that fall almost \$28 million dollars short of a 5% payout. (See Exhibits A and B) These numbers suggest that something could be very wrong in the management and/or spending practices of this foundation. Although there could be some legitimate, legal reasons that the numbers appear as they

do, this may also be an example of a foundation that the IRS or some other regulatory body should look into in more detail to ensure that this foundation is assuming sufficient responsibility for the funds it is controlling and is not taking advantage of its tax exempt status.

B. Value of Average Investment Assets Under Section 4942

One of the further complexities of Section 4942 becomes obvious when it stipulates that a private foundation must “distribute at least 5% of the fair market value of the foundation’s *noncharitable assets*” (Stern and Bartlett A-3). Although, this statement simply restates the 5% payout requirement, it adds complexity with the mention of non-charitable assets. In the distinction between charitable and non-charitable assets, there is further room for foundations to distribute less money than they could to their mission oriented causes.

The essential detail implicit in this requirement is that any assets used to carry out the foundation’s exempt purposes do not count towards the total asset base from which the 5% is ultimately computed. That is, “administrative assets such as office equipment and supplies used by employees or consultants of a private foundation for the administration of the foundation’s charitable activities, may be excluded from the minimum investment return base” (Stern and Bartlett A-5). Also, the cost of the portion of the building out of which the foundation’s grant making activities occur will not count towards the value base of a foundation. These costs, and any others that can be justified as charitable expenses, will be treated as deductions from the total value of a foundation, will reduce the base from which the 5% is calculated, and consequently will also reduce how much the 5% turns out to be. Because charitable expenses both count towards the 5% payout requirement and act as deductions towards the calculated asset base of a foundation, these

expenses appear to serve a dual purpose that reduces the amount of grants foundations give in not only one, but two different ways.

I am not saying here that it would make sense for the total asset value of a foundation to include its charitable assets and expenses, it clearly would not. I am merely trying to point out that, with this portion of Section 4942, there is no incentive for foundations to be at all frugal with their spending on rent, buildings, salaries, furniture, and many other expenses that go into the charitable activities of the organization and into their 5% payout.

C. Other Odds and Ends

With the 1969 Tax Reform Act, an excise tax of 4% was placed on the net investment income of private foundations and was reduced to 2% for tax years beginning after September 1977 (Freeman 61). Currently, the federal excise tax “is set at 1 percent of a foundation’s annual investment income for a foundation that maintains or increases its level of giving, or 2 percent for those that do not” (Ableson). The issue of the excise tax (Section 4940) is important for two reasons. First, it is important because some foundations are electing to pay the higher tax at the expense of additional grantmaking. Second, this is notable because some foundations count their excise tax payment as part of their 5% qualifying distribution which is a further example of a legally legitimate reason for foundations to give less.

The New York Times article “Some Foundations Choose to Curb Donations and Pay More Taxes” provides a prime example that is relevant to Indiana. The article explains that, in 1998, the Lilly Endowment elected to pay the higher tax rate which amounted to an additional \$6 million in taxes (Abelson).

There are clearly some problems with the way that this tax functions. The biggest problem is that a foundation may fear away from significantly increasing its grants in a given year because if it reduces its giving the next year it will have to pay the higher tax rate. However, in the question of how much foundation money is reaching mission oriented causes, the more important issue with the excise tax is that a significant number of charitable dollars are going to the government instead of to non-profit organizations and activities that would further help the foundations work towards their goals and objectives.

One other dimension to briefly highlight in the question of how much foundation money actually reaches communities and causes is that of the administrative and salary expenditures of the non-profit organizations carrying out various projects and programs with foundation dollars. I have no numerical data on this issue, but there are clearly hundreds of millions of foundation dollars that are paying salary, administrative, and overhead costs for a variety of the non-profit organizations that they fund. This raises the question of whether a greater number of people are living off of philanthropic dollars, with their salaries, benefits, etc., than are benefiting from those philanthropic dollars as a result of the services that many non-profit organizations provide. Although I am only briefly mentioning this issue, I think it is a critical one to examine. Some real thought should go into the impact of foundation dollars as they are currently being used for projects and programs. For example, it would be interesting to explore whether, in some cases, for example with poverty, a direct transfer or a direct transfer along with some services would have an equal or greater impact than the current services being provided by non-profit organizations with foundation dollars.

III. Philosophical Backdrop

The issues that I have dealt with in this paper have been mostly practical, focusing on what actually happens with the 5% payout that foundations both use and distribute for charitable purposes. However, I feel that before exploring this practical question in any more extensive way and clearly before presenting any “solutions” to the potential abuses I have highlighted, there are some more philosophical questions and issues that need to be examined. That is, my entire question of how much foundation money actually reaches the community presupposes that meeting public needs and the needs of various communities is the purpose of these foundations. I am assuming that foundations exist to alleviate or solve social problems by getting as many resources (financial, educational, etc.) as they can to the communities that their missions identify. Yet, given the current state of foundations and foundation funding, I am not entirely convinced that this is the goal. Thus, before concluding this paper with some suggestions and further areas to explore, I will briefly present some current thinking about the role of foundations in American society.

Stewart and Bartlett suggest that “the role of private foundations has traditionally been one of taking risks, innovating and responding more quickly than the government or other institutions in identifying and meeting needs” (A-29). A number of different foundations and individuals view private foundations in this way. Michael Porter and Mark Kramer echo this idea and appear to place a great deal of responsibility on foundations when they say that “foundations can and should lead social progress... if foundations serve only as passive middlemen, as mere conduits for giving, then they fall short of their potential and of society’s expectations of them” (Porter and Kramer 121-2).

Peter Frumpkin, a critic of many aspects of foundations and an individual with high expectations of them, feels that:

In recent decades, foundations have not always taken full advantage of their tremendous freedom and resources... There are few if any contemporary equivalents to the Rockefeller Foundation's grants to combat yellow fever, the Carnegie Corporation's early support of public libraries around the country, or the Scaife Foundation's 1948 grant that helped establish the laboratory in which a cure for polio was eventually discovered. By contrast, it is extremely difficult to think of a single contemporary social problem—be it the performance of schools, the rise in drug abuse, or increasing urban violence—for which foundations can be identified as having played a significant curative role over the past three decades (Frumppkin 84).

This comment from Peter Frumpkin is one that needs to be more fully examined and discussed. Before deciding if the 5% payout requirement should change in amount, in where it is distributed, or in how it is distributed, it is essential to have a more clear and agreed upon idea of why foundations exist. Founders, employees, and recipients of foundations as well as the general public must begin to examine what the purpose of foundations is or should be that sufficiently justifies their tax exempt status and the tax benefits that they provide to their donors. Do they exist to help remedy “the poverty rate [that] still hovers just below 14 percent of the population [which amounts to] some thirty-eight million Americans” (Eisenberg 176) or the estimated homeless population of more than 750,000 each night that is projected to increase at a rate of 5 percent per year (Eisenberg and Abrams 78)? Or, do they exist to bring innovative ideas to bear on a variety of issues, to provide a tax break to the wealthy, to remedy an insufficient amount of public goods being provided by government and the market, to provide an illusion that injustices and inequalities are being sufficiently dealt with or remedied, or for some other reason? Questions, such as these, are absolutely critical to examine before any policies regarding foundations should be made.

Another issue closely related to the role of private foundations is whether they should exist in perpetuity. When Congress was in the process of passing the 1969 Tax Reform Act, Senator Gore in the Finance Committee “pressed vigorously for a 25-year limit on the lives of foundations” (Troyer 22). In a recent Newsweek article about the impact and additional stresses that the recent bull market has had on private foundations, Les Lenkowsky suggested that “foundations consider putting themselves out of business by giving everything away over 20 years or so” (Spragins 49) so as not to have to deal with these types of pressures. Going back to Frumkin’s comments, another legitimate question to look at is whether foundations would be better able to address pressing social needs if they did have specific, quantifiable outcome goals and/or an identified time frame within which they would put themselves out of business by solving or, at least, alleviating some of the most pressing social problems.

One last thing to keep in mind, with these grand questions of why foundations exist and what their role is in solving social problems (if any), is some of Nicholas Lemann’s comments on “the limits of charity.”

Lemann says that with charities,

you can provide something to people who need it, but you can never guarantee that everyone who needs it will get it. Even the mammoth Ford Foundation... couldn’t possibly afford to provide day care to all the children whose mothers’ benefits will be terminated under the new welfare law. To put something under the purview of government is to make a commitment to its essential importance (37).

Lemann’s comments are well stated and open up a very different, and important, area of discussion about the relationship that foundations have with government.

This brief discussion about the role and purpose of foundations only begins to scratch the surface of the many different complicated and complex issues that need to be more fully examined before any additional legislation or changes in legislation should be considered and implemented.

IV. Conclusion

As of 1996, private foundations had \$267.6 billion in assets and made grants totaling \$13.8 billion (Salamon 26). More recent figures suggest that “foundations now hold over \$330 billion in assets and contribute more than \$20 billion annually to educational, humanitarian, and cultural organizations of all kinds” (Porter and Kramer 121). Thus, there is an immense amount of money being spent and given by foundations each year.

In the time since the Tax Reform Act of 1969 was passed, there has been endless discussions about what the appropriate payout percentage should be. It is my contention that the mandatory payout percentage is of great importance, but should not be the center of discussion and debate. Instead, the dialogue must first turn to a more philosophical one that focuses on the role that foundations are to play in American society and then to a more practical discussion of the payout percent and the various legitimate uses of payout dollars, including how much can be spent on salaries, administrative, and other expenses. I feel strongly that these \$330 billion dollars worth of assets could be having a far more positive impact than they are currently. It is clear that it takes much more than money to deal with, alleviate, and begin to solve social problems. However, if foundations were able to play a key role in remedying such situations as yellow fever and polio in the past, there is no reason that they should not be able to play equally influential roles today with some of our more current and pressing social needs. As Porter and Kramer so eloquently

suggest, “some of the money that foundations give away belongs, in a sense, to all of us. That is why we look to foundations to achieve a social impact disproportionate to their spending. We look to them to create real value for society” (122).

At the very least, the percent of foundation assets paying for salaries, administrative expenses, and excise taxes needs to be looked at much more carefully. With the gargantuan sizes of foundations today, such as Gates, Ford, and others, a mere 1% or even ½% of their assets in dollar terms is substantial. If a \$15 billion dollar foundation spends even 1% of its assets in wasteful or questionable ways, it amounts to \$150 million dollars that could have been spent on alleviating poverty, homelessness, or providing health care. My concern is that foundations do not take these billions of charitable dollars as serious as they should. When there are people living in cardboard boxes on a street in Los Angeles known as Skid Row and tons of other serious social problems, it seems that a greater sense of urgency both on the part of foundations and government is absolutely essential. \$150 million dollars is no insignificant sum. It could purchase 1500 one hundred thousand dollar houses or could provide 7500 jobs that would pay a salary of \$20,000 for a year. It is therefore my hope that a significant amount of attention will now turn to the various ways that foundations use and account for their payout and that the uses and potential abuses are taken more seriously by the government, by the foundations, and by the general public. Foundations are holding their grantees increasingly accountable to use funds effectively and to produce identifiable results. It is now time to make sure that foundations also identify concrete goals and are held accountable to use their resources effectively in furthering their objectives and overarching missions.

ⁱ This discussion will focus only on private foundations. My exploration does not include community foundations as they are generally created as public charities and therefore must not follow many of the rules and regulations imposed on private foundations. Further, since community foundations, as public charities, can be beneficiaries of the 5% payout from private foundations, have a broader funding base, and exist to

support and enrich the communities in which they are located, they do not belong in the following discussion.