PRIVATE FOUNDATIONS: PAYOUT AND PERPETUITY

Foreword

My inspiration for this paper came out of two interests that have coalesced since I came to Columbia Business School, namely my expected career path in Private Wealth Management and a desire to contribute to society in some meaningful way. When I registered for CPM last semester, I was still searching for a mechanism that would allow me to combine the two. Then it hit me: Private Foundations. Of course. Many of my future clients will have the opportunity to allocate money to philanthropic endeavors through the establishment of a Private (or "Family") Foundation, which offers numerous financial and psychic benefits. My feeling is that if I can raise awareness of these benefits among potential founders and guide founders through the process of formulating their philanthropic goals, I can serve both their interests and the interests of society as a whole. Therefore, my goal for this paper was to learn more about Private Foundations, particularly the aspects that will be most relevant to my clients. In researching this topic, I discovered that one of the key issues concerns the notion of "payout" – distributions from Private Foundations by way of expenses and grant-making. As this issue runs to the core of why donors establish Foundations in the first place, I decided it was an ideal topic for my paper.

Introduction

There has been ongoing debate concerning the payout level made by Private Foundations (heretofore "PFs") in the U.S. each year, reflecting a divide between what is *de minimis* required by law and what some consider of greater social value. At issue is the fact that many, if not most PFs, are structured and operated to exist in perpetuity. This, which warrants a lower annual payout rate, construction is defended by proponents as prudent stewardship of the endowment assets for future generations. Critics point to evidence that the mandated minimum payout has acted as both a ceiling and a floor, with widespread convergence from a majority of PFs proof that their interest and the public interest are at odds. They believe that PFs should be focused on their social mission rather than on ensuring their continuity. Which view will prevail? To answer this one must examine the reasons that PFs exist in the first place. That is the goal of this paper. To this end, I have divided the paper into three sections. The first section offers an overview of PFs – what they are, and how, by whom, and with what purpose they are established. The second section explores the tax issues surrounding PFs and attempts to uncover the government's implicit view on PFs by looking at how they are regulated and by comparing the tax treatment they receive to that of Community Foundations. The third section looks directly at the payout ratio itself – how its current level was set; what influence it has on PF spending; the case for and against perpetuity; and recent legislation regarding the payout ratio. I conclude by giving my own views on the payout issue and by speculating where the industry may be headed.

1. Overview

Private Foundations (PFs) are nongovernmental, nonprofit institutions endowed with private funds that distribute money in the form of grants to other nonprofits. They are managed by their own trustees and managers whose responsibility it is to manage current disbursements in addition to the underlying assets.

There are approximately 40,000 private foundations currently in existence with assets of nearly $500B. They distribute an average of just over 5% of assets, doling out more than $30B in grants each year. Two-thirds (25-30,000) of PFs are family managed and three-quarters have less than $1M in assets, which means that the bulk of the grants comes from the mega-foundations. The growth in PFs in recent years has been enormous, with more formed in the past 10 years than during any other 10-year period in history[1].

So what makes PFs so attractive to donors, and what accounts for the recent surge in asset flows into PFs? My research shows there are seven primary reasons why donors manage their charitable activities through a PF:

1. To avoid unnecessary death, gift, capital gains and income taxes by providing donors with an immediate tax deduction based on the amount and the form of capital given and the donor's adjusted gross income (AGI);
2. To establish a long-term or even perpetual family institution that maintains the family name, legacy and wealth into future generations;
3. To give the family a means of controlling both charitable disbursements and the charities' use of those funds;
4. To formalize the family's charitable plans and objectives;
5. To create a vehicle that both encourages family members and descendents to get involved in philanthropy, and serves as a unifying family force;
6. To provide income to current and future generations either for work as managers or trustees of the PF or as compensation for charitable activities that they perform directly;

[1] National Center for Family Philanthropy homepage

7. To achieve influence and stature in the local community or within a charitable or religious institution.

Part of the growth in PFs can be explained by the creation in the last ten years of a significant amount of new wealth, mainly by entrepreneurs but also by top corporate executives. This wealth has generally been concentrated in highly appreciated stock positions. Before President Bush cut the capital gains tax to its current 15%, it was extremely costly to sell out of these positions in order to diversify one's wealth. This increased the relative attractiveness of charitable transfers, which also generated a current tax deduction. What made PFs in particular such a popular vehicle "can be summarized in one word: control."[2] This is particularly evident when one considers the comparative tax advantages of other charitable instruments, which I look at in Section 2. As an alternative to direct bequests or *inter vivos* giving, PFs allow donors to guide behavior while establishing a legacy that can exist in perpetuity.

Paul Schervish and John Havens have written extensively on the subject of what drives people to give to charity. One of their articles was included in a recent Brookings Institution publication entitled *Death and Dollars*.[3] In it, they theorize (based on studies and interviews with wealthy families) that "identification" and "surplus value" can be used to explain why the wealthy give to charity. Donors give to people and institutions with which they feel a connection or "identification." So we are inclined to give first to close family and friends, and then to charities or institutions with which we identify. This is absolutely consistent with the idea of philanthropy, which means "love of man." Schervish and Havens quote Boulding, who writes that "Obviously, the more an

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[2] Volunteer Legal Handbook, 7th Edition, Ch. 6: Private Foundations
[3] Death and Dollars: The Role of Gifts and Bequests in America, Brookings Institution, 2003

individual identifies with some cause, community or organization, the more likely he is to support it and the greater will be his donations to it." [4] By extension, I would argue that the reason PFs are so appealing to wealthy donors is that they provide maximum "identification" – both in terms of what the foundation supports, and through the identity of the foundation itself. Of course, before a donor can feel comfortable transferring wealth out of his estate to a PF, he must first achieve "surplus value". This is defined as the "positive difference, if any, between the stream of resources (for self, family, and investment) and the stream of expenditures." [5] The more positive this surplus value, the more inclined a potential donor is to give to charity and the greater the donations are. Again, this makes sense in that it provides an explanation for the recent growth in charitable giving in general and PFs in particular, since greater wealth implies a larger aggregate surplus value. For the super-wealthy, incremental gains in wealth can result in large increases in charitable giving. In 1997, estates without a surviving spouse valued over $20M allocated 49% of assets to charitable bequests, up from 41% in 1995 and 34% in 1992. [6]

From my own experience, I've discovered that wealth management firms have a vested interest in getting closer to their clients, since this increases the likelihood that clients will transfer more custodial and investment assets to a firm, and decreases the likelihood that clients will leave the firm and go elsewhere. As such, many firms are actively encouraging clients to consider what their charitable objectives may be, are and providing advice on what options best express those objectives. Firms clearly realize that discussing and adopting long-term wealth planning and philanthropy gets them much closer to the

[4] Ibid, p. 133
[5] Ibid, p. 144-145
[6] From the Opinion Pages, Chronicle of Philanthropy, Jan. 11, 2001

client than simply managing assets. Moreover, there is further financial incentive in PFs for wealth management firms, since firms can charge fees for setting up the structure, managing the assets and frequently for acting as corporate fiduciary.

2. Tax Issues

Although tax avoidance is rarely the primary reason why donors establish PFs, without the tax benefits that PFs offer it is highly unlikely the industry would be even a fraction of its current size, and might not exist at all. However, donors face an interesting trade-off by opting to use the PF to express their philanthropy in preference to alternative vehicles. The following chart shows that direct gifts and even Community Foundations offer greater tax benefits than PFs: (the larger % is for gifts of cash, the smaller % is for gifts of stock).

FORM OF GIVING

	Direct Gifts	Community Foundation	Private Foundation
Deduction Limits of AGI*	30 or 50%	30 or 50%	20 or 30%
Income Tax Payable	N/A	None	1%**
Required Annual Distribution	N/A	None	5%
May be Passive Donor	Yes	No	Yes

* This percentage of donor's Adjusted Gross Income is the limit of the annual charitable deduction, with a 5-year carryover for gifts that exceed this AGI %.

** Used to be 2% until the passage of the CARE bill (HR 7) on September 17, 2004

As one can see, donors to a PF are giving up 10% in deductibility. In addition, the PF is required to pay an excise tax of 1% and distribute at least 5% of its assets annually. The tradeoff can thus be expressed as follows: as the donor surrenders control, he or she gains tax advantages and reduces administrative costs, and vice versa. PFs may be a creation of the tax code, but since, as illustrated, there are more tax-efficient mechanisms for giving to charity, other considerations are clearly taking precedence in the minds of PF donors. Of these, the ones that are most relevant to our discussion of payout in section 3 are parts

(2) and (3) of my list above – legacy and control. I will argue that these important factors make it unlikely, in the absence of further government regulation, for the majority of PFs to increase their payout rates.

So what accounts for the discrepancy in tax treatment and distribution of assets between PFs and Community Foundations/direct charitable giving? Understanding this may offer some clues as to how Congress may act in the future with respect to payout rates. According to the *Volunteer Legal Handbook*, "Congress has perceived [PFs] as carrying a high risk of abuse, and has closely regulated them. In addition to the 2% excise tax (now 1%) on investment income, there are other excise taxes imposed on [PFs] that are penal and intended to regulate their behavior as opposed to generating revenue." [7] One of the origins of this apparent lack of trust was Howard Hughes' attempts to shelter millions of dollars of his personal estate from tax – money that was later funneled by the PF back into business-related activities. By requiring PFs to actually pay out a minimum amount of assets each year to fund charitable activity, Congress is ensuring that PFs are actually doing what they are intended to do. The less favored status of PFs as compared to Community Foundations can be explained by looking at the activities that each is engaged in. PFs give grants and may monitor the use to which their money is put, whereas CFs actually operate charitable programs. This difference and the fact that Congress is concerned with regulating PF "abuses" imply Congress understands that the creation of many PFs is motivated less by altruism and more by opportunities for "identification" and tax avoidance. However, as I will illustrate in section 3, recent Congressional regulation has not hindered the ability of PFs to exist in perpetuity. In fact,

[7] Volunteer Legal Handbook, 7th edition, Ch. 6: Private Foundations

if we look further back in history, it is clear that Congress has no problem with perpetuity at all.

3. Payout

PFs were first regulated by the Tax Reform Act of 1969, which imposed penalties for excess business holdings and self-dealing, and established the payout requirement. At that time, PFs were required to distribute the *greater* of (1) realized income on investments, or (2) a percentage of assets that could reach 6.75%, at the Treasury Department's discretion.[8] This changed in 1976 when Congress fixed the percentage in (2) at 5%, though the clause on investment income was not changed. In 1981, Congress finally did away with this clause, fixing the minimum payout at 5%. The "so-called 'minimum distribution requirement'…is designed to prevent excessive retention of assets within foundations."[9]

What do these regulations reveal about the legislative view on perpetuity of PF assets? Comparing the minimum distribution requirement in 1969, 1976 and 1981 to the prime rate in each year as a proxy for inflation (8.5%, 7.25% and 20% respectively), we can see that there is little evidence of intent to limit the freedom of PFs to operate in perpetuity. Otherwise, Congress would have set the minimum threshold closer to the prime rate. In fact, the Treasury's report recommended an even lower minimum of 3-3.5%, with fewer regulations or penalties.[10] Moreover, we can infer from the easing of the required payout between 1969 and 1981 that Congress was, if anything, giving PFs greater latitude to build up assets and maintain their purchasing power if they so wished.

[8] Council on Foundations, Fall 2000 Board Briefing
[9] Prudent Stewards or Pyramid Builders? Distribution Policies of Private Foundations, Sansing and Yetman, September 2002
[10] Private Foundations as a Federally Regulated Industry: Time for a Fresh Look? John Simon, NYU, 1999

The reason the minimum distribution level is such a sticking point in this debate about payout is that it tends to act as both a floor and a ceiling, as the current average payout hovering just above 5% attests. Before 1981, the average payout was closer to 8%. As a result, those wishing to increase the payout rate among PFs in order to free up more capital to deal with today's social issues advocate a higher minimum distribution rate.

In the Charitable Giving Act (H.R. 7), the House version of the C.A.R.E. Act of 2003 (S. 476), they nearly got their wish. Before the passage of this bill, there was enormous concern among foundation executives (and donors) that Congress would change the rules again by requiring that 100% of the payout be in the form of grants. Previously, the 5% had included administrative and operating expenses with the result that up to 2% of the 5% distribution was allocated for expenses and only the remainder was paid out in grants. Congress was reacting to media reports that uncovered further abuses within PFs, where some family trustees had received excessive compensation, and some trustees and executives had spent lavish sums of money on travel and entertainment, including the use of a private jet – all billed as part of the 5% payout.

Massive lobbying ensued on the part of the PF industry, with the main argument against change being that the growth and current strength in the foundation sector was due to foundation leaders *not* spending out their endowments. This argument rested on two key assumptions. The first was that forcing a PF to spend 1-2% more than its current spend rate on administrative and operating expenses would threaten its long-term viability, since "payout rates higher than 5% are not sustainable…"[11] One could counter this by pointing to 2002 data that shows that 45% of PFs received new grants or gifts and, in addition earned another $1.9B from noninvestment revenue and $300M from rental

[11] PANO (Pennsylvania Association of Nonprofit Organizations), Action Center Campaign July 15, 2003

income, on top of their investment income.[12] The second argument was that if, as a result, it was not possible for most PFs to exist in perpetuity, there would be a strong disincentive for donors to establish PFs. Both of these assumptions, and the main argument, basically say the same thing: it is better (presumably for society) for PFs to be able to exist in perpetuity. The economics supporting this view have been hotly debated, with both parties using different discounted cash flow analyses and projections to support their position, which I will not address here. (For more on this debate, see Paul Jansen of McKinsey and Michael Klausner of Stanford Law School, whom are the leading thinkers on the issue of payout and whom address this in detail.)

The bill that was finally passed on September 17, 2004, though a clear slap on the wrist against recent practices, was a watered down version of what many had feared (or hoped for). The bill set compensation caps on "disqualified" personnel (i.e. non-administrative or management) of $100,000 and allowed only economy class travel, with anything in excess to be barred from inclusion in the 5% distribution. It also excluded any administrative expenses not directly attributable to "direct charitable activities, grant selection activities, grant monitoring and administrative activities…"[13] Perhaps to mitigate these "penalties", the bill also reduced the excise tax on investment income from 2% to 1%.

What can we infer from the most recent legislation? Like its original predecessor in 1969, its regulations were enacted to curb foundation abuse. And like the 1969, 1976 and 1981 bills, it did not expressly limit PF perpetuity. In fact, for the PFs that were not abusing the

[12] Foundation Fury, Rick Cohen, Shelterforce Online Issue #130, July/August 2003
[13] H.R. 7, Section 105

system, the most recent bill actually enhanced their ability to maintain purchasing power by reducing the excise tax by 1%.

4. Conclusion

So, we have seen that Private Foundations are set up by donors for many reasons related to "identification," among which is the desire to establish a lasting or even perpetual legacy. They are managed by most foundation executives to exist in perpetuity, as illustrated by the average payout rate and the fierce reaction to the perceived threat of H.R. 7. Congress has yet to express an explicitly contrarian view, except to regulate abuses related to self-dealing, tax avoidance and excessive retention of assets. My prediction is that most foundations will continue to manage their assets with a long-term or even perpetual time horizon, and that Congress will allow them to do so. There are of course exceptions. Julius Rosenwald, one-time chairman of Sears, Roebuck and Co., ordered his foundation to spend itself out of existence within 25 years of his death, a target which it surpassed by 10 years in 1941.[14] His rationale was that immediate needs were more pressing and needed to be dealt with rather than preserving capital for future unknown needs, which anyway future donors would be able to take on. Aaron Diamond and Charles Feeney are other notable donors who acted similarly, albeit Feeney for rather different reasons.[15] However, these are exceptions. Absent further regulation on Congress's part, the perpetual Private Foundation is the model that persists.

Should we care one way or another? It depends on where we fall with respect to the various arguments by the Foundation lobby that I referenced above. If we believe that the net present value of foundation contributions to society would be greater if the minimum

[14] David Bank, article in Wall Street Journal, September 10, 2002
[15] Ibid

distribution rate were to be raised, we would argue for a higher rate. However, this is a complicated issue. Would less money flow into Private Foundations if the "lasting legacy" aspect were threatened? If so, would that money make its way to charity through other vehicles, or would it instead be transferred to heirs and through taxes to the government? It is very difficult to predict how this would play out without being able to study a similar event for clues.

My own view is that, insofar as the rapid growth in Private Foundations is due in part to donors' ability to express identification motives through a philanthropic vehicle, it is a good thing. I believe that the more involvement individuals and families have with social causes, the more closely they will align themselves with those causes and the more money that will therefore be raised on behalf of those causes.

APPENDIX:

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3. Council on Foundations, Board Briefing #1: Payout, "Preserving foundation endowment value over time Vs. Spending more on current needs", Fall 2000
4. National Center for Family Philanthropy, homepage

5. Northcott, Alan (Max Bell Foundation) and Uytterhagen, Shelley (Carthy Foundation), "Practices and Policies of Private Foundations in Canada", July 2002
6. Pennsylvania Association of Nonprofit Organizations, July 15, 2003, Action Center Campaign
7. Pierson, James, "The Insider's Guide to Spend Down: Switching off the lights are the Olin Foundation", March/April 2002, The Philanthropy Roundtable
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11. Stanford Social Innovation Review, January 16, 2004, SSIR Forum: "Payout and Perpetuity"
12. Volunteer Legal Handbook, 7th Edition, Chapter 6: Private Foundations