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Philanthropy Roundtable

PRIVATE FOUNDATIONS AND THE 5 PERCENT PAYOUT RULE

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EXECUTIVE SUMMARY

- PRIVATE FOUNDATIONS PLAY AN IMPORTANT ROLE IN THE CHARITABLE SECTOR BY SUPPORTING CIVIL SOCIETY AND SERVING COMMUNITY NEEDS. AROUND 125,000 GRANTMAKING FOUNDATIONS COLLECTIVELY DONATE OVER $100 BILLION TO CHARITABLE CAUSES EVERY YEAR.
- SINCE THE PASSAGE OF THE 1969 TAX REFORM ACT, PRIVATE FOUNDATIONS HAVE BEEN SUBJECT TO STRINGENT RULES AND REGULATIONS BY THE INTERNAL REVENUE SERVICE (IRS). ONE OF THE MOST IMPORTANT RULES IS THE 5 PERCENT MINIMUM DISTRIBUTION RULE, WHICH REQUIRES PRIVATE FOUNDATIONS TO DISTRIBUTE 5 PERCENT OF THE FAIR MARKET VALUE OF THEIR ASSETS EACH YEAR FOR CHARITABLE PURPOSES.
- THE 5 PERCENT FIGURE WAS CHOSEN AS A BENCHMARK TO STRIKE A BALANCE BETWEEN ENSURING THAT PRIVATE FOUNDATIONS PROVIDE SIGNIFICANT RESOURCES FOR CHARITABLE ACTIVITIES IN THE NEAR-TERM WHILE ALLOWING FOUNDATIONS TO PROVIDE LONG-TERM SUPPORT TO CHARITIES.
- IN RECENT YEARS, WE HAVE SEEN A REVIVAL IN POPULIST RHETORIC AS CRITICS OF PRIVATE PHILANTHROPY ARGUE FOR HIGHER FOUNDATION PAYOUT REQUIREMENTS AND OTHER ONEROUS NEW RULES.
- RESEARCH ON PRIVATE FOUNDATION PAYOUT TRENDS SUGGESTS SUCH PROPOSALS ARE UNWARRANTED AND MORE LIKELY TO REDUCE CHARITABLE GIVING IN THE LONG RUN, TO THE DETRIMENT OF CHARITIES AND THE MOST VULNERABLE IN OUR SOCIETY.

INTRODUCTION

Through private foundations, Americans have established an unrivaled reputation for their exceptional commitment to philanthropy, generously providing private funds to serve the common good. Philanthropy Roundtable's vision is to foster and sustain a dynamic American philanthropic movement, where private foundations continue to play a pivotal role in fortifying our free society. Charitable organizations are instrumental in strengthening our communities and are fueled by private foundations that provide a consistent and reliable source of funding for charities and their initiatives.

Foundations reflect a vibrant diversity of charitable goals and their long-term financial commitments allow for strategic planning and the implementation of impactful, creative projects. While many charitable initiatives require strategic long-term giving, there are also major charitable projects that require large one-time investments. For example, the initial investment of endowing a chair at a university, building a new museum or medical research facility, creating a scholarship endowment fund, or establishing a new school all require a large one-time investment.

According to the latest available data, there are around 125,000 domestic grantmaking foundations registered in the United States.[1] In 2022, private foundations provided over $105 billion in charitable giving, up from almost $103 billion in 2021. Even after adjusting for inflation, private foundation giving has roughly doubled over the past 15 years and quadrupled over the past 25 years.[2]

As our charitable sector seeks to address society's most pressing problems and to provide aid to those in need, it is confronting mounting policy challenges. To help support this work, lawmakers must refrain from imposing additional barriers and restrictions on the charitable endeavors of private foundations dedicated to fulfilling their organizational missions and serving their communities.

This report reviews the historical background that led to the establishment of the 5 percent payout requirement for private foundations, analyzing the reasons behind the selection of this specific figure. Additionally, it provides an overview of contemporary criticisms surrounding the distribution requirement, with some asserting the rate is inadequate or should exclude specific charitable expenses.

Subsequently, the paper offers an extensive examination of comprehensive data and literature concerning foundation payout patterns. This analysis encompasses payout rates, investment returns of foundations, distributions by family foundations, and the legal, albeit rare, transfer of funds from foundations to donor-advised funds.

1 Author's calculations of total grantmaking foundations based on foundation codes in the Internal Review Service Exempt Organizations Business Master File.

2 "Giving USA 2023: The Annual Report on Philanthropy for the Year 2022." https://givingusa.org/. June 20, 2023.

ORIGINS OF THE 5 PERCENT PAYOUT RULE

Following World War II, charitable foundations experienced a surge in government oversight over the span of two decades. Between 1915 and 1955, the number of foundations, especially small family foundations, had grown from a mere 27 organizations to over 4,100.[3] This significant growth, coupled with rising populist anxieties about concentrations of wealth, sparked nearly twenty years of congressional scrutiny in the post-war era.

During the 1950s, a series of congressional and Treasury Department reports, predominantly led by Democratic politicians from southern states, gave rise to widespread skepticism and hostility toward charitable foundations. One notable example was Congressman Edward Cox (D-GA), who established a select committee in 1952 to investigate foundation activities.[4] Cox, known for his support of segregationist ideas, made allegations against the Rockefeller Foundation and accused the Rosenwald Fund of exacerbating racial tensions in the southern United States.

In the 1960s, there was a noticeable increase in congressional hearings, led by Congressman Wright Patman (D-TX), who chaired the House Committee on Banking and Small Business. In 1961, Patman initiated an investigation based on his belief that foundations were employed by the wealthy to safeguard their own class interests.[5] His primary focus revolved around opposing progressive foundations such as the Ford Foundation, which he perceived as advocating for internationalism and civil rights. In 1962, Patman's report scrutinized 534 foundations with combined assets exceeding $10 billion, and it was soon followed by a Treasury report in 1965. These investigations revealed cases where certain foundations amassed significant assets without distributing proportionate grants, as well as instances of self-dealing.[6]

3 Lankford, James E. "Congress and the Foundations in the Twentieth Century." Wisconsin State University, 1964.

4 Lankford. "Congress and the Foundations." 1964. pp 34-36.

5 Brilliant, Eleanor L. Private Charity and Public Inquiry: A History of the Filer and Peterson Commissions. Bloomington: Indiana University Press, 2001.

6 United States Senate Committee on Finance. Treasury Department Report on Private Foundations. 1965.

Although government reports concluded the majority of organizations investigated were compliant with the law, Congress pursued legislation to address potential issues highlighted by the Treasury report. The 1969 Tax Reform Act (TRA) introduced a new set of restrictions and regulations for these organizations. Among the key provisions for private foundations was the requirement for an annual payout. While discussions considered payout rates in the range of 3 or 3.5 percent of foundation assets, policymakers eventually settled on a payout equivalent to either the total net income or 6 percent of the market value of foundation assets, whichever was higher.[7] The 6 percent figure was deemed appropriate based on the assumption that foundations would be able to earn an 8 percent return on their investment, which after accounting for inflation (assumed to be 2 percent) would allow them to exist in perpetuity with a 6 percent annual payout.[8]

However, the 6 percent payout requirement led to serious problems for foundations, particularly with the economic turmoil and record levels of inflation in the 1970s. While real market returns in the 1960s might have been around 6 percent, from 1970 to 1979 real market returns were negative. According to one report in 1970, more than half of private foundations earned less than a 6 percent return and many foundations shifted their investment strategies away from long-term performance to seek higher returns.[9] A second report found similar results with most foundations failing to attain a 6 percent return in 1973.[10]

As a result, many private foundations simply couldn't afford to comply with the new payout rules and following the passing of the 1969 TRA thousands of foundations were liquidated, cutting off a long-term support stream for charities across the US. According to one report submitted to the Senate Subcommittee on Foundations in 1974, almost 5,000 non-operating foundations had terminated their status since the passing of the 1969 TRA—representing approximately 15 percent of all non-operating foundations in existence in 1969.[11]

As private foundations struggled to meet their charitable goals to comply with the 1969 payout requirements, Congress reduced the payout requirement from 6 percent to 5 percent in the Tax Reform Act of 1976.[12] The IRS subsequently revised its rules in 1981, setting the minimum payout rate at 5 percent of net assets, which has been the standard payout requirement for over four decades.

HOW THE 5 PERCENT PAYOUT IS CALCULATED

Specifically, Section 4942 of the Internal Revenue Code stipulates private foundations must distribute 5 percent of the fair market value of their assets each year for charitable purposes.[13] The 5 percent distribution includes the total dollar amount of grants paid out to 501(c)(3) organizations, plus the total amount of eligible expenses (necessary operating expenses).

The fair market value of foundation assets is

7 Shoenfeld, Marcus. "Initial Impressions of the Treasury Report on Foundations," Cleveland State Law Review 12, no. 2 (1965), 295.

8 See Congressional hearings: Long, Russell B. Tax Reform Act of 1969: HR 13270 (Hearing). Washington DC: House Committee on Finance, 1969.

9 Labovitz, John R. "The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements." The Journal of Legal Studies 3, no. 1 (1974), 63-105.

10 "Report and Recommendation to the Commission on Private Philanthropy and Public Needs of Private Philanthropic Foundations." Council on Foundations, Inc, 1975.

11 Council on Foundations, Inc, 1975.

12 H.R.10612 - Tax Reform Act. Washington DC: House Ways and Means | Senate Finance, 1976. https://www.congress.gov/bill/94th-congress/house-bill/10612.

13 26 U.S. Code § 4942 - Taxes on Failure to Distribute Income. Cornell Law School, n.d. https://www.law.cornell.edu/uscode/text/26/4942.

calculated as the average value of investment assets over a 12-month period. It is important to note that investment assets do not include certain charitable use assets.[14] Once accounting for additional expenses, such as the 1.39 percent excise tax on investment income, a foundation can calculate whether its charitable distributions comply with the 5 percent minimum requirement. The law also allows a private foundation to deduct 1.5 percent of its assets from the calculation for a cash allowance. Cash allowance is a reasonable sum of cash needed to cover administrative expenses and other normal and current distributions.

Foundations that fail to comply with the 5 percent minimum distribution requirement are subject to a 30 percent excise tax on the undistributed income and an additional 100 percent tax is triggered if the deficient distribution isn't made up within ninety days of receiving notice from the IRS.[15] For example, a foundation with $10 million in assets which fails to distribute any money to charitable organizations in a given year will be subject to $150,000 in excise taxes. Failure to distribute the 5 percent minimum after ninety days of receiving notice will result in an additional $500,000 excise tax. In this instance, a foundation is required to pay a total of $650,000 in excise taxes for failing to distribute $500,000 in grants to charity.

The table below illustrates how the 5 percent minimum distribution is calculated for a hypothetical foundation with $10,000,000 in assets (12-month fair market value) and $1,000,000 in investment income. The calculation for minimum payout is assets ($10 million) minus cash reserves ($150,000) multiplied by 5% (0.05) plus excise taxes owed ($13,900) = $506,400.

Item	Amount	Explanation
Foundation Assets	$10,000,000	12-month average fair market value of assets
Cash Reserve/Allowance	-$150,000	Law allows 1.5 percent of endowment value
Investment Income	$1,000,000	Dividends, interest, rents etc.
Excise Tax	$13,900	1.39% tax on investment income
Payout Rate	5% (0.05)	Law requires a minimum 5 percent payout
Minimum Payout Requirement	$506,400	Assets – cash reserves * 0.05 + excise taxes owed

14 For example, certain Private Foundations have artwork whereby the artwork is considered a charitable use asset. Some Private Foundations own their own building that is used to carry out their programs. These examples would not be included in the calculation even though they are assets of the Foundation.

15 Taxes on Failure to Distribute Income - Private Foundations. Internal Revenue Service, April 25, 2023. https://www.irs.gov/charities-non-profits/private-foundations/taxes-on-failure-to-distribute-income-private-foundations.

CRITICISMS OF THE 5 PERCENT PAYOUT RULE: OLD ANXIETIES, NEW PROPOSALS

While critics of the 5 percent payout requirement have proposed varied "remedies," the underlying arguments of those who believe the payout requirement is inadequate are by no means original. A key criticism of private foundation activity during the 1969 tax reform debates was the perceived disconnect between the tax-exempt status of private foundations and the funds that charitable organizations were receiving from foundations in the form of grants. At the time the Joint Committee on Taxation noted that "While the donor may have received substantial tax benefits from his contribution currently, charity may have received absolutely no current benefit."[16]

Another common criticism is that foundations should refrain from building up assets for future distributions and instead prioritize grantmaking to charities today. This critique rests on the assumption that the needs of the world are more urgent today than the needs of the world in the future. Critics therefore argued foundations should be subject to higher payout requirements to ensure the public benefited from the tax-exempt charitable sector.

Again, in the late 1990s and early 2000s, private foundations came under increasing scrutiny from critics of the payout requirement as robust economic growth fueled growing foundations assets. Some groups argued foundations should increase their payout rates—an argument which eventually became proposed legislation.[17] In 2003 the House of Representatives proposed prohibiting private foundations from counting administrative expenses as qualifying distributions—a de facto payout increase that overlooked the fact that many foundations approach grantmaking thoughtfully and with attention to due diligence.[18]

One common theme among the critiques made against private foundations in the 1960s and again at the turn of the 21st century was the fear of concentrated wealth and the idea that private foundations were hoarding funds and not distributing grants to charities. As we demonstrate later in this primer, the data and existing literature show these criticisms were – and continue to be – unfounded.

Today the criticisms of private foundations and the 5 percent payout requirement are largely rooted in the same ideas about concentrated wealth and the perceived failure of foundations to pay out adequate amounts to charitable organizations. For example, the progressive Institute for Policy Studies (IPS) argues wealthy individuals use private foundations to reduce their tax burdens, rather than distributing funds to public operating charities.

In a 2022 report published by IPS, authors Chuck Collins and Helen Flannery refer to private foundations as "wealth warehousing vehicles."[19] Again, the underlying arguments remain the same, whether we are talking about 1969, 2003, or 2023. To remedy the alleged "wealth warehousing," the authors of the IPS report recommend doubling the annual payout requirement from 5 percent to 10 percent of a foundation's assets.

Aside from proposed changes to the payout rate, other critics of private philanthropy have taken a more nuanced approach by proposing

16 General Explanation of the Tax Reform Act of 1969, HR 13270, 91st Congress. Staff of the Joint Committee on Internal Revenue Taxation, 1970.

17 Mehrling, Perry. "Spending Policies for Foundations: The Case for Increased Grants Payout." National Network of Grantmakers, 1999.

18 H.R.7 - Charitable Giving Act of 2003. Washington DC: House - Ways and Means; Education and the Workforce | Senate - Finance, n.d. https://www.congress.gov/bill/108th-congress/house-bill/7.

19 Collins, Chuck, and Helen Flannery. Gilded Giving: How Wealth Inequality Distorts Philanthropy and Imperils Democracy. Institute for Policy Studies | Charity Reform Initiative, 2022.

reforms to the definition of what constitutes a qualifying distribution for payout calculation purposes. Boston College Professor Ray Madoff has argued the broad definition of "qualifying distributions" means that foundations can satisfy their 5 percent payout obligation without actually supporting charities with grants.[20]

One of the ways Madoff argues foundations do this is by making up a large share of their distributions with administrative costs such as paying salaries. Madoff argues that "This rule allowing unlimited administrative expenses is more troubling in the context of small family foundations where a significant portion of the administrative fees is likely to flow to the donor's family and friends."[21]

Based on this critique, Madoff suggests the need for legislation similar to the 2003 proposal in the House of Representatives, which would have excluded administrative expenses from the payout requirement for all foundations. More recently, legislation has been introduced in the 117th Congress that aimed to prohibit family foundations from expensing the administrative costs of working family members.[22] As we reveal in a later chapter of this report, the critique regarding the allocation of funds toward administrative expenses is not well-supported by empirical evidence.

Another more nuanced critique that has gained momentum in recent years is opposition to private foundations counting grants to donor-advised funds (DAFs) as qualified distributions. As a sponsoring organization composed of contributions made by individual donors, DAFs are 501(c)(3) organizations, which means grants to DAFs are counted as qualifying distributions by the IRS. However, critics of DAFs say current payout requirements are insufficient, as funds in DAFs can remain in these accounts for long periods of time, delaying the flow of money to charitable organizations.[23]

For this reason, DAF critics suggest private foundation grants to DAFs should not be counted toward the 5 percent payout requirement. As Madoff notes: "This ability to avoid payout rules by contributing to a donor-advised fund is difficult to justify in light of temporal logic of the payout rule."[24]

This line of thinking has inspired political efforts to limit private foundation use of DAFs. In 2021, Senators Angus King (I-ME) and Charles Grassley (R-IA) introduced the Accelerating Charitable Efforts (ACE) Act, which would have prohibited private foundations from counting donor-advised fund (DAF) grants toward their 5 percent payout rate.[25] The ACE Act was not passed into law, but the Treasury Department and IRS issued a guidance plan in 2022 that suggested they are examining similar issues, specifically mentioning changes to distributions involving DAFs.[26]

While some proposals to change private foundation payout rules do not directly change the payout rate, they do effectively increase the payout requirement by excluding administrative costs and grants to donor-advised funds as being counted as qualifying distributions.

20 Madoff, Ray D. "The Five Percent Fig Leaf." Pittsburgh Tax Review 17, no. 2 (2020).

21 Madoff, Ray D. "The Five Percent Fig Leaf."

22 "S.1981 - ACE Act." Congress.gov. Accessed August 18, 2023. https://www.congress.gov/bill/117th-congress/senate-bill/1981.

23 Andreoni, James, and Ray Madoff. "Calculating DAF Payout and What We Learn When We Do It Correctly." NBER Working Paper 27888, 2020.

24 Madoff, Ray D. "The Five Percent Fig Leaf."

25 What's in the ACE Act, S.1981/H.R.6595? Philanthropy Roundtable, 2022. https://www.philanthropyroundtable.org/wp-content/uploads/2022/03/Whats-In-The-ACE-Act-Overview.pdf.

26 McGuigan, Elizabeth. "Biden's Proposed Budget Threatens Private Foundations." Philanthropy Roundtable (blog). April 4, 2022. https://www.philanthropyroundtable.org/bidens-proposed-budget-threatens-foundations/.

PRIVATE FOUNDATION PAYOUT RATE: WHAT WE KNOW

To assess claims by foundation payout critics about the concentration of wealth and the purported failure of foundations to pay out adequate funds to charities, it is helpful to review the existing data and literature on payout trends. Luckily, an abundance of studies provide a comprehensive overlook of average and median payout rates for private foundations.

FoundationAdvocate provides a robust estimate of the average foundation payout rate using giving as a percent of three-year average assets for the years 2008 to 2018.[27] The results reveal an average payout rate that typically fluctuates between 7 percent and 9 percent. With similar results, one 2018 study published in the Journal of Wealth Management examines the payout trends of over 12,000 private foundations between 2006 and 2010.[28]

The authors find an average multiyear payout rate of 7.25 percent, which is largely consistent with the existing literature and the findings of the annual Foundation Giving Forecast Survey. Using giving data from the Giving USA annual report and private foundation asset figures from the financial accounts data of the Federal Reserve, we can estimate the average annual payout rate for private foundations from 2010 to 2022.[29]

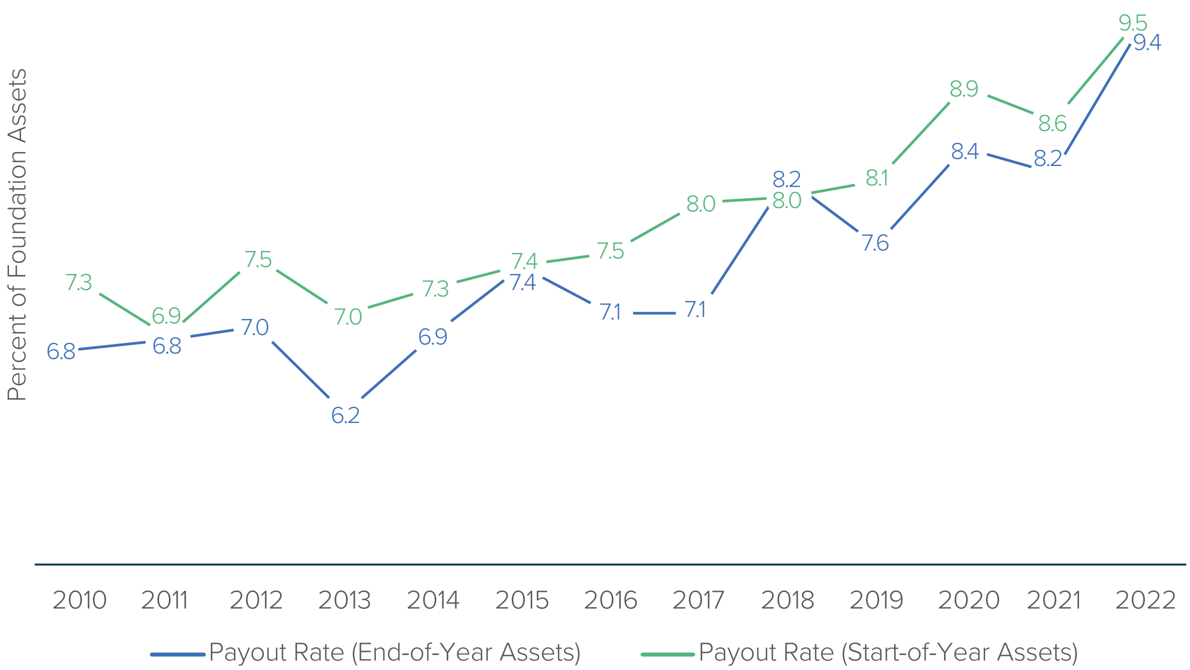
27 "How Much Do Foundations Give Per Year?" FoundationAdvocate – Tracking the Investment Performance of Private Foundations. Accessed July 12, 2023. https://www.foundationadvocate.com/foundations-payout/.

28 Afik, Zvika, Arie Levy, and Hagai Katz. "Philanthropic Foundations Payout and Multiyear Grants: Between Giving Today and Giving Tomorrow." The Journal of Wealth Management 20, no. 4 (2018), 33-45.

29 For asset figures see: Federal Reserve - Financial Accounts of the United States - Z.1 - Current Release. Board of Governors of the Federal Reserve System, 2023. https://www.federalreserve.gov/releases/z1/; for giving figures see: "Giving USA 2023: The Annual Report on Philanthropy for the Year 2022." https://givingusa.org/. June 20, 2023.

Figure 1 below shows that average payout rates are typically between 6 percent and 9 percent each year, with the average over the thirteen-year period being around 7.5 percent. The chart shows both payout rates using start-of-year assets and end-of-year assets. As the law allows private foundations to make required distributions by the end of the year following the year on which the 5 percent calculation is based, the start-of-year calculation provides a more accurate representation of the actual payout rate.

Fig 1. Average Payout Ratio of Private Foundations: 2010-2022



Sources: Giving USA 2023 Annual Report and Federal Reserve - Financial Accounts of the United States.

The data reveal the average payout figure for private foundations is typically above 7 percent, which suggests foundations are paying well above the 5 percent minimum requirement on average. However, payout critics often argue a small number of foundations with large payouts may skew the averages higher, so it is useful to also consider data on median payout rates. The Foundation Center published a study in 2012 that calculated both the mean and median payout rates for 1,170 large foundations.[30]

From 2007 to 2009 the study found a median payout to net assets ratio of 6.2 percent. When looking specifically at endowed foundations (which tend to have lower payouts), the study found the median payout rate to be 5.8 percent and an average payout rate of 8.6 percent. Interestingly, the study found that around one-in-ten foundations had payout rates below the 5 percent minimum. But as the authors point out, this was generally due to carryover of undistributed income for later years or due to rapid asset growth. Private foundations have up to one year from the close of the current year to meet the payout requirement. Some foundations, especially large ones, use this extension, which often distorts the median payout measurement downward when based on a single reporting year.

30 Renz, Loren R. “Understanding and Benchmarking Foundation Payout.” Foundation Center, 2012.

Other studies on median payout rates have found similar results with the payout often being close to 5 percent, but typically above the 5 percent minimum rate. A 2018 study found the median payout rate among more than 12,000 foundations was slightly above the legal minimum at 5.14 percent.[31]

Similarly, an IRS fact sheet report reviewing domestic private foundations in 2018 found that among more than 100,000 990-PF returns, the median payout rate was 5.5 percent, with a range of 5.2 to 6.2 percent depending on foundation asset size.[32] Another report published by the University of Colorado in 2022 reviewed the activities of the 100 largest non-operating foundations in the state.[33] The report found a median 5-year payout rate of 5.24 percent and an average 5-year payout rate of 6.86 percent.

Finally, a 2020 report commissioned by the Council of Michigan Foundations analyzed nearly 50,000 yearly filings for both national private foundations and Michigan foundations.[34] The report found median payout rates between 5.5 and 5.9 percent at the national level and between 5.8 and 6.2 percent for foundations in Michigan. The report also found median payout rates among endowed foundations were lower, at 5.3 to 5.7 percent, while non-endowed foundations had median payout rates of 60 percent or more.

SUSTAINABLE PAYOUTS REQUIRE SUSTAINABLE RETURNS

While the available data and literature show private foundations have average payout rates above 7 percent and median payout rates above 5 percent, it is important to consider the relevance of foundation investment returns when discussing payout requirements. As we noted earlier, the 5 percent figure was chosen as a benchmark to ensure that private foundations provide a significant number of resources for current charitable activities while still allowing for long-term asset growth and stability. With median payout rates between 5 and 6 percent, private foundations would need to see real investment returns of at least that level in order to continue operating and providing long-term support to charitable organizations.

The Council of Michigan Foundations (CMF) has been conducting regular studies on foundation investment returns for over two decades. In its earlier analyses, these CMF studies calculated the probability of a foundation maintaining its real value over time based on different hypothetical payout scenarios. In a 2000 study of thirty-three Michigan foundations over a twenty-five-year period, foundations had a 58 percent probability of maintaining their real asset value with a 5 percent payout mandate and only a 43 percent probability if the payout mandate was 6 percent.[35]

The study found the real return of the pooled thirty-three foundations during the period 1973-97 was 5.27 percent. Importantly, the study noted that "Only the 5% payout rule comes closest to preserving purchasing power and level of payout for the hypothetical portfolios in this period." Subsequent studies commissioned by CMF found similar estimates for foundation real investment returns. A 2013 study by Cambridge Associates LLC found average real returns of 5.11 percent for the period 1973 to 2010, while an updated

31 Afik, Zvika, Arie Levy, and Hagai Katz. "Philanthropic Foundations Payout and Multiyear Grants: Between Giving Today and Giving Tomorrow."

32 Domestic Private Foundations, Tax Year 2018. Internal Revenue Service, 2018. https://www.irs.gov/pub/irs-pdf/p5505.pdf

33 Ely, Todd L. "Foundations of Colorado." University of Colorado, August 2022. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4478524.

34 Williams, J., Veach, C., & Kienker, B. An Evaluation of Private Foundation Model Portfolios, Investment Returns, & Payout Rates. Council of Michigan Foundations. 2020.

35 "Sustainable Payout for Foundations." Cambridge Associates, Inc. | Council of Michigan Foundations, April 2000.

analysis in 2016 found average real returns of 5.28 percent for the period 1973 to 2015.[36] A 2022 study observing long-term investment returns of private foundations found that nominal ten-year annualized returns fluctuated between 4.6 and 9.7 percent between 2014 and 2021.[37]

Averaged over the entire eight-year period (2014-21), nominal returns were 7 percent. During that same period, consumer price inflation averaged 1.9 percent, which means that real investment returns for private foundations were marginally above 5 percent on average in recent years after accounting for inflation.

While past foundation investment returns data is useful for making assumptions about future returns, forecast models are also useful tools for calculating potential future foundation investment returns. The 2020 CMF report included a ten-year annualized real returns forecast and found a range of estimates including an optimistic 6 percent real return and pessimistic real returns of less than 4 percent.[38] Another forecasting model published in 2019 in the Journal of Policy Modeling argued future returns were likely to be lower than those based on historical parameters.[39]

Using lower equity and bond return assumptions, the authors found the assets of foundations would be significantly reduced with a 5 percent payout requirement and completely depleted with a payout of 7 percent. The authors noted "Not only do low payout rates mean greater longevity, they also mean greater giving capacity, and consequently, greater impact potential."

Using a Monte Carlo Simulation model, we can forecast hypothetical returns for private foundations and calculate the impact of different payout rates on asset performance over time. Forecasting ten years into the

future with the same 35 percent fixed income model portfolio used in the 2020 CMF study, we used Vanguard's Capital Markets Model (VCMM) to run simulations of foundation assets

36 Bignami, Petra G. "Sustainable Payout for Foundations: 2013 Update Study." Cambridge Associates LLC, March 2013; Council of Michigan Foundations. "Sustainable Payout for Foundations: 2016 Update Study." Cambridge Associates LLC, 2016.

37 "Study of Investment of Endowments for Private and Community Foundations." Council on Foundations–Commonfund, 2022.

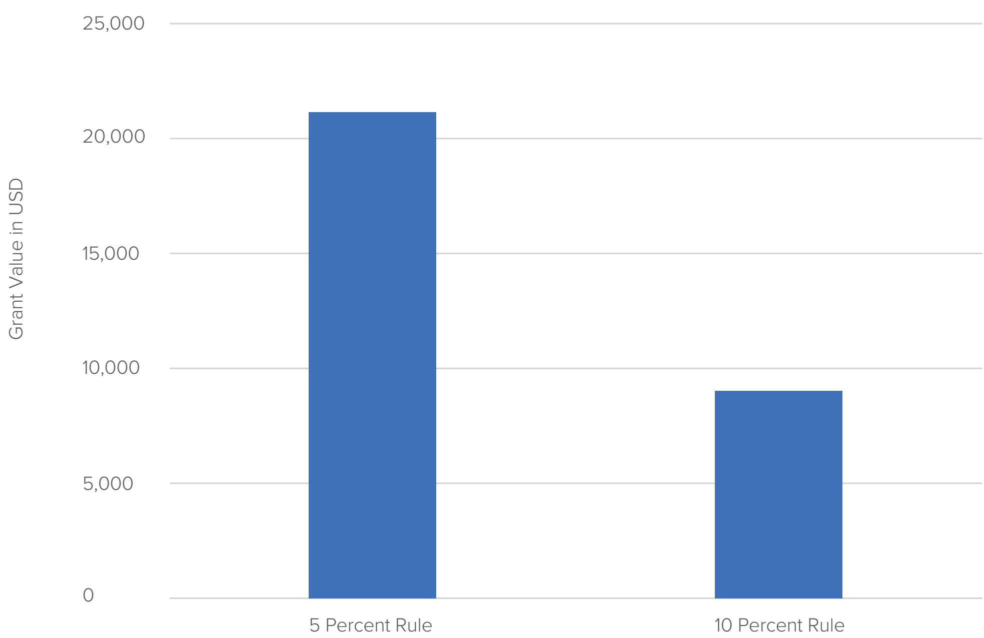
38 Williams, J., Veach, C., & Kienker, B. An Evaluation of Private Foundation Model Portfolios, Investment Returns, & Payout Rates. Council of Michigan Foundations. 2020.

39 Afik, Zvika, and Hagai Katz. "Reconsidering the philanthropic foundation minimum payout policy under a "new normal"." Journal of Policy Modeling 41, no. 2 (2019), 219-233.

using different payout requirements.[40] The chart below depicts real grant payout amounts for the median foundation after a 30-year period. The result is based on a hypothetical foundation with a 35 percent fixed income portfolio and a starting balance of $1 million.

The median return is estimated to be 4.5 percent, while the real (inflation adjusted return) is estimated to be just 1.7 percent. As a result, median foundation assets declined to $929,867 or just $707,232 adjusting for inflation. In other words, the median foundation loses almost 30 percent of its purchasing power over ten years. In this simulation the consequence of shrinking foundation assets means the real payout amount for the median foundation declines from $50,000 today to about $37,000 after ten years and around $21,000 after thirty years. Under a 10 percent payout requirement, as suggested by the Institute for Policy Studies, the median real payout declines to less than $9,000 per year after thirty years. This means that under a 10 percent payout requirement the real median foundation grant is less than half that of a foundation grant using the 5 percent payout rule after 30 years—a notable drop in charitable giving. It is worth noting the 10 percent payout rate is promoted as a policy reform aimed at increasing funds paid out to charities, yet this policy prescription would significantly reduce long-term giving by foundations.

Fig 2. Hypothetical Real Median Grant After 30 Years



*A 10 percent payout rule would cut the real median grant amount by more than half after 30 years for this hypothetical foundation, with a 35 percent fixed income portfolio and a starting balance of $1 million, compared to the current 5 percent payout rule.

40 Monte Carlo Simulation Model estimates from: Portfolio Visualizer. https://www.portfoliovisualizer.com/; Vanguard Capital Markets Model (VCMM). https://corporate.vanguard.com/content/corporatesite/us/en/corp/what-we-think/v-family-models.html

It is important to consider the impact of foundation investment returns on payout requirements. The 5 percent payout rate was chosen to strike a balance between providing resources for charitable activities and ensuring long-term asset growth. Existing studies and available data consistently demonstrate that the 5 percent payout rule comes closest to preserving the purchasing power of private foundations, providing a consistent and reliable source of funds for charities over the long run. What's more, forecasts of future investment returns suggest even a 5 percent payout requirement could restrain the long-term activities of some foundations, while higher payout requirements would lead to a significant decline in real dollar payouts over time.

HOW OTHER COUNTRIES REGULATE FOUNDATION PAYOUT: A COMPARATIVE ANALYSIS

The debate surrounding the 5 percent foundation payout requirement often revolves around the advantages it brings to charities and the significance of sustaining long-term grantmaking activities. However, it is worth considering another aspect: the lack of viable alternatives for comparison. Exploring a comparative analysis of foundation payout regulations in other countries might provide fresh insights that could enrich the ongoing discussion in the United States.

In Canada private foundations are required to meet an annual disbursement quota that mandates 3.5 percent of their assets must be spent on charitable activities or gifts to nonprofit organizations. Foundations in Canada must disburse this 3.5 percent of the average value of assets during the twenty-four months before the current fiscal year in which the disbursement is being made.[41] In the 1970s the disbursement quota was set at 5 percent, but this rate was lowered to 4.5 percent in the 1980s and then revised down to 3.5 percent in 2004 to better reflect long term rates of return over time. However, the Canadian government's 2022 budget included an increase in the disbursement quota (starting in 2023) to 5 percent for foundations with assets in excess of $1 million with the intention of boosting charitable grants during the recovery from the COVID-19 pandemic.[42]

Unlike Canada, most countries don't have payout rates based on foundation asset sizes. In Europe many countries don't have numerical payout requirements for foundations, while others have payout rules that stipulate a need to spend a certain share of foundation income every year. For example, in Sweden private

41 "Disbursement quota calculation." Government of Canada (canada.ca). Last modified April 7, 2017. https://www.canada.ca/en/revenue-agency/services/charities-giving/charities/operating-a-registered-charity/annual-spending-requirement-disbursement-quota/disbursement-quota-calculation.html.

42 A Plan to Grow Our Economy and Make Life More Affordable. Government of Canada (canada.ca), 2022. https://www.budget.canada.ca/2022/home-accueil-en.html.

foundations are required to pay out 80 percent of their net income averaged over the preceding five-year period for charitable purposes.[43]

Importantly, net income does not include capital gains or business income but does include interest and dividend income. Similarly, in Spain private foundations are required to pay out 70 percent of their net income averaged over three years.[44] Finally, in Germany a private foundation is allowed to retain one third of its net income to preserve its endowment—meaning that two thirds of interest and dividend income must be spent for charitable purposes.[45]

To illustrate the differences in payout trends in the United States and Germany, the table below compares the US-based Ford Foundation's actual payout rates from 2019 to 2021 with a hypothetical application of German payout rules.[46] The actual payout rates of the Ford Foundation have fluctuated between 5 and 6.6 percent, averaging 5.8 percent over the three-year period. Applying the German payout rules, the payout ratio averages about half a percent and never reaches 1 percent in any of the three years observed. From a comparative point of view, the costs of complying with foundation payout rules are considerably higher in the United States than in most other countries—in this case, Germany.

Application of German Payout Rules on U.S. Foundation

	FY2019	FY2020	FY2021
Assets ($)	$13,139,164,109	$13,816,992,095	$18,087,669,295
Dividends & Interest ($)	$129,149,200	$81,559,261	$125,807,802
Charitable Disbursements ($)	$660,191,600	$908,071,226	$1,065,405,858
Required U.S. Payout (%)	5%	5%	5%
Actual U.S. Payout (%)	5%	6.6%	5.9%
Required German Payout (%)	0.7%	0.4%	0.5%

*Calculations do not include excise taxes on investment income or cash allowance figures.

*Asset, income, and disbursement data is from the Ford Foundation's annual 990-PF for years 2019-2021.

43 Johansson, Dan, Mikael Stenkula, and Niklas Wykman. "The Rise of Private Foundations as Owners of Swedish Industry: The Role of Tax Incentives 1862–2018." SSRN Electronic Journal, 2018.

44 De la Calleja, Lourdes M. 2020 Legal Environment for Philanthropy in Europe: Spain. Philanthropy Advocacy, 2020.

45 Nonprofit Law in Germany. Council on Foundations, 2022. https://cof.org/content/nonprofit-law-germany.

46 Authors calculations based on Form 990-PF, FY2019-2021.

DISTRIBUTIONS BY FAMILY FOUNDATIONS

An increasingly popular critique of private foundation payout rules today revolves around the notion that the broad interpretation of "qualifying distributions" means foundations can satisfy their 5 percent payout obligation without actually supporting charities with grants. Critics argue that foundations employ a strategy to achieve this by allocating a substantial portion of their distributions toward administrative expenses, such as paying salaries and travel expenses. These criticisms are often targeted at family foundations specifically. For example, Madoff has stated: "People are told that they can hire their children to work in the private foundation and they can spend their... time in Bermuda and deduct those expenses for when they have their family meeting."[47] Based on this position, Madoff and others have suggested excluding administrative expenses from the payout requirement.

If family foundations were extensively misusing their funds for these purposes, there would likely be a noticeable increase in their administrative expense ratios versus those of independent nonfamily foundations. Luckily, existing data and studies offer valuable insight on this important topic. An Urban Institute study published in 2006 reviewed the expense and compensation data of the 10,000 largest foundations by giving and documented the differences between family and nonfamily foundations.[48] The report found that as family foundations grew larger, the ratio of expenses to total giving declined, but nonfamily foundations did not report the same trend.

The authors said: "The difference in charitable expense levels between family and nonfamily independent foundations was greatest for the largest foundations—less than 4 percent compared to over 8 percent." These findings are significant precisely because they demonstrate that, contrary to what critics argue, family foundations are actually more efficient in their administration than nonfamily foundations and they become more efficient as their operations grow over time.

A subsequent study published by the Urban Institute in 2008 asked the important research question, "What Drives Foundation Expenses & Compensation? Results of a Three-Year Study".[49]

47 "Are We Giving Fast Enough? Donor-advised Funds and the State of Philanthropy." American Enterprise Institute - AEI. February 26, 2021. https://www.aei.org/events/are-we-giving-fast-enough-donor-advised-funds-and-the-state-of-philanthropy-2/.

48 Boris, Elizabeth T., Loren Renz, Asmita Barve, Mark A. Hager, and George Hobor. "Foundation Expenses & Compensation: How Operating Characteristics Influence Spending." The Urban Institute, the Foundation Center, and Philanthropic Research, Inc, 2006.

49 Boris, Elizabeth T., Loren Renz, Rachel Elias, Mark A. Hager, and Mahesh Ashekhar. "What Drives Foundation Expenses & Compensation? Results of a Three-Year Study." The Urban Institute, the Foundation Center, and Philanthropic Research, Inc, 2008.

Contrary to the claims of family foundation critics, the study found family foundations tend to have a smaller percentage of administrative expenses than nonfamily foundations and family involvement actually reduces administrative expenses. The study's authors note the lower median expense-to-qualifying distribution ratios for family foundations compared to nonfamily foundations suggests "Family members hold staff-related costs down by providing free program administration and other help."

To determine whether the differences between family and nonfamily administrative expenses have held over time, Philanthropy Roundtable published a policy brief in 2021 that dug into data for a group of sixteen foundations that supported proposed restrictions.[50] The results of the analysis suggest there is little difference between family foundation and nonfamily foundation expense ratios. Specifically, the eight nonfamily foundations studied had an average expense ratio of 10 percent, while family foundations had an average ratio that was slightly lower, 9 percent.

Another study published by Philanthropy Roundtable in 2021 reviewed the administrative expense data of forty foundations (twenty family foundations and twenty nonfamily foundations) for the tax year 2018.[51] The author found the average administrative expense ratio among family foundations analyzed was 11 percent, whereas the average ratio among independent foundations was 15 percent.

Since there is clearly no evidence that family foundations misuse funds for administrative expenses, it's also worth examining whether criticisms can be tied to overhead cost increases in recent years. We know from the aforementioned studies that recent foundation overhead costs typically account for between 10 and 15 percent of total expenses.

In fact, reviewing the 990 data of the fifteen largest private foundations for fiscal year 2021 we observe an average expense ratio of 13.9 percent and a median of 15.2 percent—largely in line with recent studies.[52] This can be compared to studies from 2006 and 2004 that observed median private foundation expense ratios of 16.3 percent and 13.5 percent respectively.[53] In other words, over the past two decades there has been no upward trend in the administrative expense ratio of foundations.

The critique of private foundation payout rules then, specifically regarding the allocation of funds toward administrative expenses, is not well-supported by empirical evidence. The available data and analyses spanning over fifteen years do not support the claim that family foundations extensively misuse their funds for administrative expenses. While criticisms of private foundation payout rules may still exist, it is important to base discussions and potential policy changes on accurate and comprehensive evidence to ensure fair evaluations of foundation practices.

DISTRIBUTIONS TO DONOR-ADVISED FUNDS

Another common criticism of foundation payout rules is that distributions to DAFs allow foundations to meet the minimum 5 percent payout requirement without distributing the funds directly to charitable causes. Such criticisms have gained prominence in recent years, leading to the introduction of federal legislation and expected proposed regulatory changes that would exclude DAF distributions from being counted as qualifying distributions.

50 McGuigan, Elizabeth. No Evidence Family Foundations Claim Higher Expenses. Philanthropy Roundtable, June 2, 2021. https://www.philanthropyroundtable.org/resource/no-evidence-family-foundations-claim-higher-expenses/.

51 Jezior, Serena. "Do Family Foundations Spend More On Overhead Expenses Than Nonfamily Foundations?" Philanthropy Roundtable, December 2021. https://www.philanthropyroundtable.org/resource/do-family-foundations-spend-more-on-overhead-expenses-than-nonfamily-foundations/.

52 Authors calculations based on Form 990-PF, FY2021.

53 "A Closer Look at Foundation Administrative Expenses: Benchmarking & Reporting Expenses Amid Growing Public Scrutiny." Forum of Regional Associations of Grantmakers, 2007.

Nevertheless, contrary to the notion that DAFs hinder charitable giving, numerous studies consistently demonstrate funds are donated to charities at robust rates each year.[54] Sponsor organizations overseeing DAFs impose strict regulations to ensure the timely allocation of funds to charitable causes. Median payout rates exceeding 11 percent and average payout rates ranging from 15 to 30 percent indicate DAFs play a substantial role in supporting philanthropic endeavors.[55] Furthermore, these figures increase when endowed DAFs and newly established DAFs are excluded, emphasizing the positive impact of established DAFs.

Critics also often exaggerate the proportion of private foundation grants allocated to DAFs, as the data reveal that such contributions represent a small fraction of total giving. In 2021, grants to DAF accounts amounted to less than 3 percent of all private foundation grants, while foundations disbursed an astounding $90.88 billion in grants overall.[56] These statistics underscore the fact that funds contributed into DAFs constitute a minor portion of the broader grantmaking efforts.

However, private foundations have valuable reasons for utilizing DAFs as part of their philanthropic strategies.

Firstly, DAFs allow foundations to amplify their impact by pooling resources from multiple donors, enabling the distribution of larger grants than would be possible individually. This consolidation of resources enhances the foundation's ability to support a greater number of projects and organizations.

Another important reason private foundations opt to use DAFs in their giving strategies is DAF sponsors bring valuable expertise to the grantmaking process, including knowledge of the charitable sector, due diligence processes, and legal requirements. Collaborating with DAFs allows private foundations to leverage this expertise, ensuring effective allocation and utilization of their grants.

Furthermore, DAFs offer private foundations a quick and efficient means to respond to emerging needs. In times of crises or natural disasters, foundations can swiftly provide relief and support by making grants to DAFs that specialize in addressing these specific areas.

DAFs also serve as platforms for private foundations to test new ideas and approaches to grantmaking. They offer a flexible space for experimenting with innovative strategies such as social impact investing or supporting projects with unconventional solutions. This enables foundations to assess the viability and effectiveness of these ideas before committing significant resources, promoting innovation within the philanthropic sector.

Imposing new regulations, restrictions, or payout requirements on private foundations' use of DAFs would have unintended consequences. Rather than benefiting the charitable sector, such measures would hinder the flow of funds to public charities and the communities they serve. Critics often overlook the strategic advantages and positive impact of DAFs in philanthropy. The flexibility and efficiency provided by DAFs play a crucial role in supporting philanthropic efforts and addressing pressing needs. By leveraging the expertise of sponsor organizations, DAFs enhance the effectiveness of private foundations' philanthropic endeavors. Preserving the advantages of DAFs is crucial for maintaining a vibrant and effective philanthropic sector that addresses the needs of communities and individuals.

54 Heist, Dan, and Kendra Stone. "Self-Regulating Donor-Advised Funds: An Analysis of Inactive Account Policies and Endowed DAFs." Brigham Young University, January 2023.

55 Vance-McMullen, D., & H. Daniel Heist. (2022). Donor-advised fund account patterns and trends (2017-2020). Donor-Advised Fund Research Collaborative.

56 Salmon, Jack. "Much Ado About Private Foundations Using DAFs." Philanthropy Roundtable (blog). June 22, 2023. https://www.philanthropyroundtable.org/much-ado-about-private-foundations-using-dafs/.

CONCLUSION

Private foundations play a crucial role in the charitable sector, providing support to civil society and communities in need through annual donations exceeding $100 billion. Since the implementation of the 1969 Tax Reform Act, private foundations have been subject to strict regulations enforced by the IRS, including the 5 percent minimum distribution requirement. This rule mandates that foundations distribute 5 percent of their asset value annually for charitable purposes. The chosen 5 percent benchmark strikes a balance between resource allocation for charitable activities today and long-term asset growth and stability.

Based on comprehensive studies, data, and future return projections, it is evident the 5 percent payout rule effectively preserves the purchasing power of private foundations. While there has been a resurgence in populist rhetoric advocating for higher payout requirements and changes in measurement methods, a thorough analysis of the data and literature suggests such proposals are unjustified and likely to stifle charitable activity—resulting in fewer dollars available for our society's most vulnerable, especially over the long term.

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ABOUT PHILANTHROPY ROUNDTABLE

Philanthropy Roundtable is a nonprofit organization dedicated to building and sustaining a vibrant American philanthropic movement that strengthens our free society. To achieve this vision, the Roundtable pursues a mission to foster excellence in philanthropy, protect philanthropic freedom and help donors to advance liberty, opportunity and personal responsibility.

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