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CLIENT ADVISORY

Tax Planning in Private Foundations

Keeping an eye on what matters most

Managing the federal excise tax rate on investment income should not detract from what usually matters most to philanthropic organizations – effective grantmaking. However, simply monitoring the payout figure that qualifies a foundation for a 1 percent, rather than a 2 percent, excise tax rate may facilitate the decision to make some spending decisions before the end of the fiscal year, or not.

Just how much time and energy should be devoted to qualifying for the lower excise tax rate depends on your answers to these basic questions. (1) How much is the potential tax savings? (2) Does that amount matter? (3) Will it matter next year?

Overview

Ideally, foundation trustees would reserve the highest possible percentage of a foundation's investment income for doing good. Planning to pay less in excise taxes may mean a slight increase in funds available for grants. But the thought of tracking and planning expenditures to qualify the foundation to pay a 1 percent, rather than 2 percent, excise tax can seem like an added management burden and certainly not as interesting to most trustees as strategic thinking and site visits with interesting grantees.

At GMA Foundations, our finance staff actually enjoys the challenge of strategic tax planning. In this client advisory, Pamela Labonte Maksy describes how the GMA finance team monitors the numbers and helps clients think about the timing of expenditures.

How much is it?

Private non-operating foundations are generally subject to a federal excise tax of 2 percent on their net investment income. However these foundations can qualify for a reduced tax rate of 1 percent for any year that the percentage of their qualifying distributions for charitable purposes as a percentage of net non-charitable use assets exceeds the average distribution ratio of the preceding five tax years.

Basically, if a foundation gives out more this year -as a percentage of assets - than it did over the prior five years, it may qualify for a lower tax rate. Distributions for charitable purposes, by law, must equal at least 5 percent of the market value of the foundation's assets (with some adjustments).

Predicting which tax rate applies in the current year requires estimates of:

- the total grants paid,
- qualifying foundation operating expenses paid,
- net investment income and
- the average market value of the non-charitable use assets.

Though the applicable tax law is not lacking in its complexities, a back-of-the-envelope calculation could lead to a reasonable estimate of the current year's excise tax rate. Depending on the market fluctuations and foundation's grants cycle, the actual distribution amount to qualify for the reduced rate will likely be a moving target until the close of the fiscal year.

This is the worksheet we use to give the foundation ED or interested trustee an indication of whether to consider a change to current year disbursements.

Worksheet

4th quarter planning for the federal excise tax

all figures are estimates

		Sample Foundation
Net investment income, current year	**a**	$6,400,000
Average net assets, current year	**b**	$80,000,000
Average distribution ratio for the prior five years	**c**	.052
Charitable disbursements required to qualify for the 1 percent tax rate	b*c = **d**	$4,160,000
Charitable disbursements paid year to date + anticipated disbursements thru year-end	**e**	$4,110,000
Additional disbursements needed during current year to qualify for 1%	d-e = **f**	**$50,000**
Tax savings if foundation qualifies for 1% excise tax rate rather than 2%	.01*a = **g**	**$64,000**
Tax savings net of additional disbursements IF those are made	**h**	$14,000

In the case of the Sample Foundation (above), the Executive Director would compare the estimates of additional disbursements (f) and possible tax savings (g) and consider:

- Do the net savings (h) from a reduced excise tax rate justify the additional charitable distributions required to qualify for that rate (f)?
- Does the amount of potential net savings (h) justify the amount of management time and work that will go into potentially changing course?
- Would the additional disbursements this year (f) support the foundation's mission and grantmaking strategy?

Does that amount matter?

A sense of fiduciary responsibility inevitably leads to a number of questions, including:

- Is it important to the foundation's strategy to monitor charitable disbursements with an eye on qualifying for the reduced 1 percent excise tax rate?
- Do the anticipated tax savings this year justify increasing planned disbursements for this year?
- How will this year's decisions affect future year distribution ratios?

The simplest answer to all of these questions? **It depends**.

In all cases, grantmaking strategies and priorities should be determined by the foundation's philanthropic goals and mission. The two-tier tax rate provides both an incentive in the short term and a disincentive in the long term to increasing distribution levels.

Consider whether the tax savings is worth the time and challenges associated with trying to hit a moving target. If the foundation has modest net investment income then the savings from paying 1 percent less in taxes will also be modest.

There are times when it makes sense to keep an eye on the distributable amount that would result in a 1 percent tax rate. When might it make sense to try to achieve the lower tax rate?

- If net investment income for the year is significant, the 1 percent tax savings will be significant too.
- If the foundation is already considering charitable disbursements around year-end, a change in timing may nudge the foundation's distribution ratio into the 1 percent qualifying range.

To read about efforts to simplify the excise tax, visit:

http://www.foundationsonthehill.org/docs/Excise-Tax-Simplification-0228.pdf

http://philanthropy.com/blogs/government-and-politics/house-proposal-would-simplify-foundation-excise-tax-rate/28601

Case study A

Consider a private non-operating foundation that re-balances its portfolio mid-year, taking significant realized gains in the process.

- The difference between a 1 percent and a 2 percent tax rate represents an estimated tax savings of $35,000.
- In the final month of the fiscal year, an analysis of the distribution ratio and qualifying distributions already paid reveals that, if qualifying distributions were $7,000 higher by the end of the fiscal year, the foundation could achieve the anticipated $35,000 tax savings.
- By moving some qualifying distributions planned for the upcoming fiscal year into the current fiscal year, the foundation is able to increase the current year's distribution ratio up to what is needed to recognize the tax savings.

Will it matter next year?
Don't lose sight, though, that each year's distribution ratio affects the following years' average distribution ratio, thus pushing the 1 percent qualifying distribution ratio bar ever higher.

There may be no way to hit the 1 percent mark each year and so we advise clients to use this worksheet as a planning tool to use on the occasion when it makes immediate financial sense or is part of a planned long-term grantmaking strategy.

Case study: B

Consider a private foundation that every year monitors the distribution ratio in an effort to exceed the running 5 year average in order to qualify for the reduced tax rate each year. Over time the distribution ratio for each year increases a bit, increasing the 5 year average accordingly.

Assume that at some point the foundation ends up paying out 6 percent of their net value non-charitable use assets as opposed to 5 percent as they attempt to maintain a 1 percent excise tax rate.

This may be okay if it fits into a long-term giving strategy, but, if it does not, the foundation may need to hit the re-set button. The ideal time to do this would be in a year with modest net investment income, when the difference between a 1 percent and 2 percent tax rate is slight.

Of course, the decision to re-set should be made in light of the foundation's mission and the needs of the community the foundation serves. Philanthropic considerations may temper the amount by which qualifying distributions can or should be reduced in any given year as part of a strategy to reduce a distribution ratio.

In Conclusion
Don't sweat the small stuff. Trustees should not engage in monthly monitoring of the eventual excise tax rate – that might just take all the joy out of giving. Ideally, the trustees will rely on an advisor to monitor the numbers with the tax rate in mind, and consider changes to the timing of disbursements to support the foundation's long term goals.

This paper is a reflection on how to plan disbursements within the *current* tax law, which may change.

The Council on Foundations is currently supporting a change in the private foundation excise tax on net investment income from the current two-tier rate to a flat rate.

In their August 2012 issue paper, The Council explains their support of tax simplification. "[We have] long supported reduction or elimination of the current version of the excise tax because it has never been used as it was originally intended—to pay for IRS enforcement and oversight of the nonprofit sector. In fact, each year the government receives substantially more from the excise tax than it spends for that intended purpose."

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