COUNCIL on FOUNDATIONS

April 15, 2015

The Honorable John Thune
Co-Chairman
Business Income Tax Reform Working Group
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Benjamin L. Cardin
Co-Chairman
Business Income Tax Reform Working Group
219 Senate Office Building
Washington, DC 20510

Dear Senator Thune and Senator Cardin:

Thank you for your work with the Senate Finance Committee Business Income Tax Reform Working Group ("Working Group") and for your leadership in taking on the great challenges presented by comprehensive tax reform. To help your efforts to reform the Internal Revenue Code, the Council on Foundations ("Council") wishes to share its suggestions relating to specific tax policy provisions that have a significant impact upon the philanthropic sector. The Council believes that it is critical that tax reform improves and does no harm to these provisions so that the philanthropic sector can do its part to help meet the needs of the communities we serve.

The Council has a membership of over 1,500 grantmaking foundations and corporate giving programs which collectively grant and invest billions each year to help meet the many needs of the communities they serve. As the voice of philanthropy nationally, the Council works to create an environment in which philanthropy can grow and thrive, and seeks to promote policies that enable the philanthropic sector to work most effectively.

We affirm the strong commitment of the Council and the philanthropic community to do our part to help address the grave fiscal challenges confronting our nation. In particular, the Council recognizes that in an era of fiscal austerity, the philanthropic sector is called upon to step up to meet the needs of some of our most vulnerable communities and neighbors. At the same time, the Council urges you and your colleagues to consider that significant community needs and diminishing public dollars create increasing demands and strain on our charitable organizations. These organizations look to philanthropy – both organized structures such as foundations and individual American donors – to support their efforts. As you consider tax reform measures, we implore you to recognize that the charitable sector cannot fully step in to do more if changes to tax policy result in fewer dollars to charities.

The Council sees clearly that its members are committed to meet the challenge of increased needs. In 2011, the last year for which complete data is available, foundations contributed through grants and other means $41.67 billion to help meet the needs of the communities they serve. From 2005 through

2011, charitable contributions from individual donors actually declined—understandably so in view of the great economic hardship many Americans faced and a concomitant decline in median household incomes. Yet, over that same period, giving from foundations increased a remarkable 28.6 percent. In fact, foundation giving during that period totaled $273.24 billion, a huge commitment which made a positive difference in virtually every community in our nation. Because of the increased giving from foundations, total charitable giving over that period, which included the worst recession since the 1930s, increased.

During 2010 specifically, when community needs were highest, many donors saw a drop in their incomes and foundations saw a decline in their invested assets. Yet, because endowed philanthropic tools like Donor Advised Funds – managed by community foundations – allow donors to guide funds to future causes with intentionality, foundations were able to continue to make gifts during this difficult economic time to local housing programs, workforce development efforts, and family service organizations. If foundations had not increased giving dramatically, let alone given a constant or even reduced amount, total charitable giving would have declined at a time when resources were most needed. Tax policy will have a significant effect on whether foundations can sustain that level of grantmaking in coming years while maintaining the philanthropic legacies many foundations represent.

Our members are committed to help not only by offering their own resources, but by identifying ways in which to do more with less. Philanthropy has a proven record of using resources in highly innovative ways to achieve solutions to intractable problems, and the Council's members have realized dramatic results by leveraging their own resources to implement those innovations on a large scale. Philanthropy creates thriving communities by finding new ways to create jobs, spur community growth, support the vulnerable, and empower your constituents to improve their lives.

Philanthropy has a unique ability and freedom to take risks and innovate in ways government and for-profit entities cannot. Philanthropic organizations provided the charitable dollars and innovative thinking behind the efforts to conquer polio in the United States, eliminate smallpox worldwide, paint stripes on traffic lanes to prevent accidents, facilitate the creation of national parks and nature preserves, develop private colleges and universities, and so much more.

We ask you to pursue changes in tax policy that encourage – not stifle – the philanthropic tools that foundations rely on to invest in causes, programs, research, and activities that are essential for thriving communities.

Preserve Current Law on Donor Advised Funds

Donor advised funds (DAFs) are a unique charitable giving vehicle, allowing donors to establish charitable accounts at vetted public charities, such as community foundations, and remain involved in supporting the charitable causes and issues they care about. Community foundations control the oversight and management of funds on behalf of families or individuals, and in many cases, have the discretion to direct some of the resources to priority causes the foundation identifies.

DAFs are used exclusively for charitable purposes. DAFs engage donors and nurture greater charitable activity in a community. For example, in a recent Urban Institute survey of funds managed by community foundations, 88 percent of surveyed foundations receiving DAF funds reported that their donors participated directly in foundation-sponsored events. In addition, more than 70 percent of foundations reported that the average age of a DAF donor is between 46 and 64 years old. Furthermore, 81 percent of foundations report that their donors remain involved in the foundation or their communities after donating. These survey results highlight the unique ability of DAFs to attract and engage donors and provide an important entry point for long-term community involvement.

The Council also strongly believes in the value of endowed philanthropy. The compulsion to pay out all charitable dollars today in order to address immediate needs is woefully shortsighted. Philanthropy does not think just of the latest development, the next election, or the next business cycle. Rather, foundations must constantly be thinking of the needs of the next generation.

When our country was in the middle of a prolonged recession and community needs were highest, many donors saw a drop in their incomes and foundations saw a decline in their invested assets. However, DAF donors were able to make gifts to local housing programs, workforce development efforts, and family service organizations because they had intentionally made their charitable donation during more prosperous times. Because of their intentional gifts made years earlier with just such an economic downturn in mind, DAF donors were able to continue to give at sustained levels throughout the recession and direct their funds to needs in their communities as they arose.

DAFs are one of many invaluable philanthropic tools that community foundations use to engage donors and connect them with important local causes. The Council respectfully requests that the Working Group recommend that current law with respect to DAFs be preserved to allow charitable organizations to continue to utilize this critical tool.

Simplify the Private Foundation Excise Tax

As a general proposition, the Council encourages the Working Group to consider changes to the tax code which would help, rather than hinder, the ability of foundations to fulfill their diverse missions. In particular, the Council would like to highlight an area in which thoughtful Congressional action may significantly enhance the philanthropic sector’s capacity to serve—reform of the private foundation excise tax to a single tier, 1 percent rate.

Internal Revenue Code section 4940 requires private foundations to pay an annual excise tax equal to two percent of their net investment income; that tax is reduced to one percent in any year in which a foundation’s distributions (measured as a percentage of assets) exceed the foundation’s average payout rate over the preceding five years. The current two-tier system actually serves as a regressive disincentive to increased giving, especially in times of crisis or economic turmoil. The more a foundation gives in one year, the harder it will be to avoid the higher excise tax rate while still maintaining mission-enhancing and fiscally sustainable payouts in the years to come. Many within and outside of government have noted this unintended result.

For example, a study by Professors Richard Sansing of Dartmouth and Robert Yetman of the University of California found that current law can have “countervailing effects on foundation behavior.” The study noted that current law “creates a tax-induced incentive” to reduce contributions in “difficult economic times” such as we are now experiencing “because a high distribution this year makes it more difficult to qualify for the lower rate during the next 5 years.” In such instances, foundations subject themselves to higher tax rates in future years unless they also reduce their giving at the very times when such support is most needed. This is particularly true for smaller foundations, for whom extraordinary giving in one year has a disproportionately higher impact on the calculation.

Yet, private foundations are particularly adept at responding quickly in times of emergency, and tax policy should facilitate – rather than hinder – this generosity. For example, the John D. and Catherine T. MacArthur Foundation awarded over $7 million in the aftermath of Hurricanes Katrina and Rita for urgent needs such as mobilizing volunteers, developing affordable housing for victims, and establishing regional recovery loans. Dozens of private foundations responded swiftly to the devastating tornado that struck Moore, Oklahoma in 2013, providing victims with access to food, water, shelter, and other basic needs. Last year, the Conrad A. Hilton Foundation awarded over $1 million to nonprofits that work with refugees fleeing the humanitarian crisis in Syria. These are just three out of countless examples of private foundations acting swiftly to help communities get back on their feet after tragedy strikes. We urge Congress to remove this disincentive to pay out during these times to avoid a higher tax rate in the future. The tax code should encourage this charitable response to imminent needs instead of hindering it.

Additional externalities of a two-tier excise tax include that it drains a foundation's mission-focused operating resources, increases operating uncertainty, and mires foundation staff in unnecessary complexity, and consumes significant foundation resources spent managing exposure to the excise tax. Thus, the excise tax has a double-barreled negative impact (once as the actual tax, and once more in the form of operating costs) on the resources a foundation can offer the community it serves. Moreover, the complexity and uncertainty the two-tiered structure engenders diminishes valuable charitable resources, both funds and time.

The private foundation excise tax was enacted in 1969 to help fund what was then the new IRS office of Exempt Organizations. Yet the tax is not serving its stated purpose because the funds are not—and never have been—specifically dedicated to that office. Moreover, the amounts collected under the tax far exceed the IRS's costs in dealing with private foundations. As Eugene Steuerle of the Urban Institute stated in recent Congressional testimony, Congress should "[r]educe and dramatically simplify the excise tax on foundations. Whatever Congress gives back here will automatically be paid out to the public in the form of greater charitable activity…The current design discourages payouts today because they can increase future excise taxes (which are higher when giving tomorrow does not exceed giving today)."

There is broad support for simplifying and reducing the excise tax. For many years, tax experts and even the Joint Committee on Taxation have recommended simplifying the tax to a single, flat rate. The President has proposed simplifying the tax in several Administration Budgets, most recently his Fiscal Year 2016 Budget. More recently, H.R. 644, the American Gives More Act of 2015, which simplifies the private foundation excise tax to a single tier and reduces the rate to 1 percent, passed the House of Representatives by a wide margin. H.R. 644 also permanently reinstates several important charitable provisions, including a provision allowing donors to make tax-free distributions from their individual retirement plans for charitable purposes, the enhanced deduction under Internal Revenue Code section 170 for charitable contributions of food inventory, and a rule allowing enhanced contribution limitations for qualified conservation property. The Council applauds the passage of H.R. 644, and respectfully requests members of the Senate to bring H.R. 644 to the floor for a favorable vote.

Maintain Type II and III Supporting Organizations

Many of the Council's members currently utilize "supporting organizations" to maximize the impact of their philanthropic endeavors. Often, a supporting organization manages fundraising or investments for the supported organization to allow it to focus on its core charitable mission, whether grantmaking or providing direct services.

Under current law, three types of supporting organizations are classified as public charities. “Type I” supporting organizations are akin to a subsidiary of the supported organization in that the supported organization—generally a 501(c)(3) organization—exercises a substantial degree of direction over the policies, programs, and activities of the supporting organization. “Type II” supporting organizations, where persons supervising or controlling the supported organization exercise supervision or control over the supporting organization, are more akin to a brother-sister organization of the supported 501(c)(3). Finally, “Type III” organizations are operated in connection with one or more 501(c)(3) organizations, and must satisfy a notification requirement, a “responsiveness test,” and an “integral part test.” These rigorous standards reflect prior lawmaker attention, particularly during the Pension Protection Act of 2006 debates, ensuring that each supporting organization serves a valid charitable purpose.

Supporting organizations are uniquely beneficial to donors and the charitable organizations served by offering many types of charitable assistance. Distinct from a private foundation, supporting organizations allow donors the opportunity to partner directly with a public charity to fund one specific charitable organization. Their unique structure allows them to be effective, efficient, and flexible operator,; allowing charitable organizations to thrive under unique sets of challenges. Furthermore, whether a charitable organization would reap the most benefit from a Type I, Type II, or Type III organization varies according to the individual needs and circumstances of the 501(c)(3) supported organization.

For example, one of our community foundation members benefits from the support of a Type III supporting organization to protect its charitable assets. Because of the limited direct control over a Type III organization by the supported 501(c)(3), a Type III can be the most desirable and appropriate vehicle to secure the foundation’s assets when the supported organization’s charitable program activities involve material risk. A Type III organization can also be preferable when a donor wants to ensure that the donations will only be used to support specific charitable endeavors. A Type III organization can provide this assurance by avoiding a structure where members of the supported organization board can exercise majority control over how the funds are used, while at the same time providing the supported organization with a voice in these decisions.

Similarly, Type II supporting organizations have their own unique benefits. These organizations are under control of the same leadership as the supported organization (this relationship is also known as "brother/sister" organizations), which allows the supported organization to be more involved in the Type II organization’s decision-making. For example, a nonprofit school may seek a Type II supporting organization to help manage its unique fundraising goals. A Type II structure would permit the school to exercise board leadership and help steer the direction of the supporting organization’s fundraising efforts on its behalf, while at the same time keeping the day-to-day management responsibilities for each organization under separate leadership.

As these examples illustrate, supporting organizations offer unique benefits to the charitable organizations they serve and are an important facet of the country’s charitable fabric. In order to allow charitable organizations the flexibility to advance their diverse charitable missions, it is critical for Congress to preserve their freedom to choose which type of supporting organization can best support their charitable work. For the foregoing reasons, the Council respectfully requests that current law which permits the creation of Type II and Type III organizations be maintained.

Additional Provisions

With respect to several additional proposals contained in former House Ways and Means Chairman Dave Camp's Tax Reform Act of 2014, the Council and its members have concerns with several provisions. We are prepared to discuss these and other issues that impact philanthropic organizations. Of particular note, we are concerned with proposals that would expand the scope of the unrelated business income tax, increase penalties imposed on private foundations for self-dealing transactions, eliminate the presumption of reasonableness when foundations are involved in excess business transactions, and require mandatory electronic filing of IRS Form 990.

Closing

The Council respectfully asks you to preserve current law regarding donor advised funds, reform the private foundation excise tax, and maintain the ability of Type II and III supporting organizations to qualify as public charities. In addition, we respectfully urge the Working Group to seek the input of stakeholders in the charitable sector before making changes to the Internal Revenue Code that will impact our foundation members. The impact of these changes will primarily be borne not by those individuals with the most resources, but by those with the least—the struggling members of our communities who rely on philanthropy to help themselves and their families meet the challenges of daily life.

Finally, we appreciate that the purpose of organizing the Working Groups was to distribute tax issues among them. In our case, there are issues that bridge the groups. For that reason, we are attaching the comments we have submitted to the Individual Working Group as an additional reference.

Thank you again for your leadership in reforming our tax code. The Council on Foundations stands ready to work with you on this crucial task.

Very truly yours,

Vikki Spruill

President and Chief Executive Officer

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Senior Vice President for Public Policy and Legal Affairs