Nonprofit Sector Research Fund

Working Paper Series

Money, Mission, and the Payout Rule: In Search of a Strategic Approach to Foundation Spending

by

Thomas J. Billitteri

The Aspen Institute

Nonprofit Sector Research Fund
Working Paper Series

Money, Mission, and the Payout Rule:
In Search of a Strategic Approach to Foundation Spending

by

Thomas J. Billitteri

July 2005

THE ASPEN INSTITUTE

Printed in the United States of America

Nonprofit Sector Research Fund

The Nonprofit Sector Research Fund (NSRF) was established in 1991 to increase understanding of the nonprofit sector and philanthropy. Since its founding, the Fund has awarded a total of $10 million to support over 400 research projects on a broad range of nonprofit topics. NSRF is currently focusing its work in three broad areas: public policy affecting nonprofits, social entrepreneurship, and foundation policy and practice. In each area, NSRF is identifying priority research topics, supporting research and dialogue on these topics, communicating research findings to appropriate audiences, and working with other organizations to facilitate the use of new knowledge to improve relevant practices and policies.

The Fund's programs are supported by the Ford Foundation, Bill and Melinda Gates Foundation, William Randolph Hearst Foundation, W.K. Kellogg Foundation, Charles Stewart Mott Foundation, The David and Lucile Packard Foundation, Skoll Foundation, and Surdna Foundation.

Publications

The Nonprofit Sector Research Fund produces a variety of publications, including *Snapshots*, concise research briefings that highlight practical and policy-relevant findings reported by Fund grantees; the *Aspen Philanthropy Letter*, an e-newsletter on new developments in the field of philanthropy; books, such as *Building Wealth* and *Organizing Foundations for Maximum Impact*; and working papers that present findings of Fund-supported research.

A complete list of publications is available from the Fund by calling (202) 736-2500 or visiting our website at www.nonprofitresearch.org. Publications may be ordered through the Aspen Institute Fulfillment Office at (410) 820-5338.

Working Papers

Working papers are not formally peer-reviewed. The Fund invites reader feedback on working papers and can convey reader comments to author(s).

A complete list of Working Papers is available from the Fund by calling (202) 736-2500 or visiting our website at www.nonprofitresearch.org. Individual copies may be ordered through the Aspen Institute Fulfillment Office at (410) 820-5338.

For further information on the Nonprofit Sector Research Fund, contact:

Nonprofit Sector Research Fund
The Aspen Institute
One Dupont Circle, NW
Suite 700
Washington, DC 20036

(202) 736-2500 / (202) 293-0525 fax
e-mail: nsrf@aspeninstitute.org
www.nonprofitresearch.org

Table of Contents

Executive Summary

For years, foundation leaders, policymakers, philanthropy scholars, and nonprofit advocacy groups have debated whether private foundations distribute a big enough portion of their assets every year for good works. More recently, the questions about this distribution, known as foundation "payout," have gained new urgency, in part because of rising demand for charitable services and money to support them, and partly because foundations have come under Congressional and media scrutiny over their spending and management practices.

The debate over payout traditionally has centered on whether the federally required, annual minimum distribution of 5 percent of investment assets should be higher, lower, or remain the same. Critics of the 5-percent level contend that foundations could pay out more in grants and still ensure that their resources last; advocates of leaving the minimum at 5 percent assert that raising it would, over time, erode foundation assets and possibly force grantmakers out of business. This report argues that moving toward a resolution of the payout debate requires foundation officials, policymakers, and researchers to progress beyond this narrow percentage approach and engage in a more strategic examination of how payout rates can better match individual foundation missions. Part of that examination requires donors to candidly consider the question of perpetuity in establishing foundations, and trustees and executives to address the same question when donors have left them discretion to do so.

Matching payout to mission is a complex exercise that requires a foundation to carefully weigh its goals, the needs of its grantees, the influences of economic cycles, and the particular nature of its philanthropic work, then seek to achieve its grantmaking objectives with the most prudent deployment of financial resources. Holding back on spending might make sense if a foundation believes needs will be greater or philanthropic approaches will be more effective in the future than they are now. An accelerated payout, on the other hand, might make sense if the foundation's goals are justifiably immediate or if a problem might grow worse if spending is deferred. The point is that strategic thinking about missions and money needs to inform every foundation's governance decisions.

A hindrance to any analysis of foundation payout behavior is a paucity of useful research data. Not enough is known about how foundations arrive at payout decisions, what processes might be in place among individual grantmaking institutions to review payout policies, and how payout practices differ among foundations of varying size, mission, and approach to perpetuity.

The discussion about payout ultimately should turn on a series of philosophical and practical questions that all foundation executives, trustees, and donors should weigh carefully and often:

- What is the proper role of private foundations in a democratic society and in what way is that role distinct from that of charities? How has my own foundation succeeded or failed at fulfilling that role?

- In what way does the quality of leadership by foundation executives, trustees, and donors affect the way payout policies are shaped and perceived? Are leaders at my foundation willing to step forward with a well-conceived agenda for payout, or are they simply following the herd in shaping their distribution policies?

- Should foundations last in perpetuity? If my foundation seeks perpetuity, what is the rationale?

Against the backdrop of such questions are specific policy issues that demand further attention. A key one is excise taxes that foundations must pay on their investment income. The current two-tiered (1- or 2-percent) approach punishes foundations for making larger-than-usual distributions in one year by raising their tax rate over the next five if they don't sustain their giving at the higher level. A consensus seems to have emerged that fixing the excise tax should be a priority for Congress. An obvious remedy would be to adopt a flat 1 percent annual tax and to use the excise revenue as it was originally intended: to improve IRS oversight of nonprofit organizations.

Another policy issue that demands further examination is how foundations should account for administrative expenses, or overhead, such as rent and salaries. Under current law, a foundation can include such payments in its payout calculation, and advocates of the practice argue that doing so can help them operate more effectively by not skimping on such work as grant application screening and grantee guidance. Critics argue that limiting or eliminating administrative expenses in payout would free up billions of additional dollars for charities and force foundations to operate more efficiently.

In an era when nonprofit institutions of all kinds are under the scrutiny of government officials and the media, foundations remain vulnerable to new congressionally imposed rules regarding their operations, including their payout. A frank dialogue among foundations — one that includes input from trustees, donors, and grantees, and focuses on how better to tie payout practices to mission —is overdue.

I: Framing the Issues

For years, private foundations and public charities, two branches of old and proud lineage, have been engaged in something of a family quarrel. Like many such squabbles, this one involves money.

At issue is the so-called payout rate —the percentage of assets that private foundations distribute in grants and other expenditures related to a charitable purpose. To put it in the most basic, non-legalistic way, federal regulations require private, grantmaking foundations to spend at least 5 percent of their investment assets each year, regardless of the organizations' mission, age, endowment size, or other variables.[1]

The foundation world believes, by and large, that the 5-percent minimum is prudent and sound, and it cites a battery of economic studies to back its position. A 5-percent payout assures that endowments will last over time and thus allow foundations to do good works, perhaps in perpetuity, advocates of this view assert. In times of weak or falling investment markets, such as those in recent years, keeping payout at or near 5 percent helps ensure against steep erosion in foundation assets, they further contend.

On the other side are those who argue that too many foundations adopt the 5 percent minimum without giving their spending policies enough thought. Some also charge foundations with stockpiling money while failing to do enough for society to justify the favorable tax treatment they receive, especially in a time of declining government support for social services. Backers of higher payout cite their own economic studies to support their view.

Regrettably, the dispute largely has been stuck there: on whether the 5-percent distribution minimum is the "right" level. Many of the arguments on each side have become predictable, the positions intractable, and the competing rationales difficult to evaluate because of a shortage of useful research. Moreover, the dispute often occurs under the radar, without the kind of open, frank airing of views that such a complex subject demands. Typically, charities that want to see greater foundation spending keep quiet for fear of jeopardizing existing relationships with grantmakers. Foundations, on the other hand, often avoid openly discussing payout for fear of inviting greater scrutiny from lawmakers, the media, and nonprofit advocacy groups.

It is time now for the debate to move beyond the narrow boundaries of percentage formulas and econometrics into a more productive sphere —one in which foundations, with input from grantees and policymakers, explore the potential for tying spending decisions more strategically to their individual philanthropic missions. While that approach is applicable to all foundations that must meet the minimum payout requirement, including corporate foundations and small family funds, it is perhaps of most significance to medium- and large-size private foundations that control the bulk of philanthropic assets.

Perpetuity and Fiduciary Duty

It is important to remember that payout is a highly complex issue, and one that offers no easy resolution. Many foundations are bound by trust instruments, wills, or bylaws that compel them to operate in perpetuity, inducing trustees to make conservative spending decisions and stick closely to the mandated distribution minimum. Even without such legal stipulations, fiduciary duty calls boards of directors to operate in the best interest of foundations —an obligation that frequently heightens the risk-averse nature of grantmaking institutions and holds down payout.

Moreover, foundations vary in both capacity for and inclination toward strategic analysis of their spending practices. Most foundations, it must be remembered, are small funds that have no paid staff members, a characteristic that, while not foreclosing the potential for thoughtful deliberation on payout, often makes it unlikely.

Then, too, the minimum-distribution requirement may have little consequence for certain foundations, like those in a spend-down mode —organizations that typically distribute all their assets in a set number of years and then go out of business. They might also include the thousands of "pass-through" foundations, which distribute a significant portion of their assets soon after receiving them.[2] Other kinds of institutions are simply not covered by the minimum-distribution requirement —community foundations, for example, which are actually public charities. Neither are university endowments.

Still, for most private foundations, big or small, aiming to last in perpetuity or not, the payout requirement has profound and far-reaching implications for the nonprofit world as a whole. If grantmakers, especially the biggest ones, don't more closely examine those implications, Congress could step in with tough new rules aimed at wresting additional money from the hands of trustees. In fact, an emerging view among foundation observers is that it is "now or never" for foundations to take the initiative on examining their records and practices on spending.

A More Intentional Approach to Payout

The solution to the payout enigma rests as much (or more) on common sense and new ways of thinking about the roles and responsibilities of grantmakers as on the familiar tools of analysis, such as econometric studies and percentage formulas. Foundation trustees, executives, and donors must do a far more deliberate job than in the past of matching their payout strategies to the missions of their organizations.

Ideas such as matching payout to mission and thinking through the rationale for perpetuity may seem self-evident to philanthropy outsiders, as well as some insiders. But too few grantmakers have taken even these elementary steps. In part, what is needed is a more intentional, and defensible, approach to payout by each foundation —a deliberate plan, in other words, that helps the foundation weigh the merits of spending more money now on good works versus deferring outlays until later.

Evelyn Brody, a law professor at the Chicago Kent College of Law and an authority on the legal and historical issues surrounding charitable endowments[3], said such a strategic approach is often lacking in the foundation world. "What could you accomplish if you spend more now than if you spend less now, but more later?" said Ms. Brody. "I would like that to be done consciously, through a strategic plan, and I don't know if it's being done at an individual foundation level."

Ms. Brody is hardly alone in that view. Other scholars and researchers echo the opinion that too many grantmakers have fallen into a comfortable pattern of paying out the legal minimum and not revisiting the issue on a systematic basis. A wide-open, spirited debate within the nonprofit world would, no doubt, shake many grantmakers from the presumption that meeting the federal minimum either fulfills their legal and social obligations or makes for effective philanthropy.

In fact, the 5-percent floor, which was instituted by Congress decades ago to ensure against hoarding of foundation assets, has for many foundations become a ceiling on grantmaking that they rarely, if ever, exceed. That is especially true of many of the largest grantmakers, which control a lion's share of foundation assets, and those that, either by choice or because of donor stipulations, expect to operate forever.

Foundations that hew closely to the 5 percent minimum typically argue that to pay out much more would be foolhardy because over time their wealth would erode, their long-range philanthropic goals would be jeopardized, and eventually they could be forced out of business. While they acknowledge an obligation to distribute some funds each year to help with immediate needs, they also claim a right —and even a duty —to protect their historic role as thought leaders and innovators in the world of philanthropy. They point to a U.S. Treasury Department document —written in the mid-1960s when foundations were under severe assault by congressional critics —that praised foundations for their ability to "initiate thought and action, to experiment with new and untried ventures, to dissent from prevailing attitudes, and to act quickly and flexibly."[4]

Often, however, it is a bigger-is-better approach that guides foundation spending policies, especially among funds that are already the richest. "There is a tendency, especially among the wealthiest of foundations, not to give much more than they have to give," C. Eugene Steuerle, a senior fellow at the Urban Institute and a former Treasury Department economist who has studied foundation payout for more than a quarter century, wrote during the stock market boom of the late 1990s. "Their fear, in part, is that if they do give more, and other foundations do not, then they lose their relative standing in the pecking order, as defined by net worth."[5]

Foundations and Government Spending

In assessing the payout question, experts such as Stanley Katz, a professor at Princeton University's Woodrow Wilson School of Public and International Affairs, dismiss the view that foundation money should be seen as a replacement for dwindling government social service aid —an idea that has persisted in an era of shrinking federal and state resources.

Mr. Katz, who has written about the history of foundations, rejects the notion that charities are entitled to support from any particular foundations. "The genius of the system is that it allows for donor choice within very broad parameters," he said. If those parameters are too narrow, "then foundations are substituting for government expenditures, and I don't think they should be forced to do that."

But advocates of higher payout reject the argument that distributing more money now to charities, especially in a time of heightened need, would undermine the historic nature or long-term financial viability of grantmakers. Foundations sit on vast piles of wealth and have a moral, if not legal, obligation to help address today's pressing social problems, they contend. And, they say, cuts in government aid for those in need make the call for greater foundation support all the more compelling. Because donors receive a tax deduction for their gifts to foundations in exchange for a promise to do good for society, they assert, relegating too much money to tomorrow's causes at the expense of today's is shaky policy and a questionable use of philanthropic resources.

The most vocal critics of foundation payout practices cast the issue in terms of social duty and equity. "What is the obligation of foundations to give money to civil-society institutions in view of the enormous tax benefits they have derived and the public purpose with which they have been chartered?" asks Pablo Eisenberg, senior fellow at Georgetown University's Public Policy Institute and a longtime advocate of higher payout. "Their response has been narrow, minimalistic, and legalistic. There ought to be a minimum that is reasonable, but ensures that an adequate amount goes to the [charity] sector. Clearly, 5 percent is inadequate."

The Question of Effectiveness

The question of whether the minimum payout rate should be raised is part and parcel of larger debates about the role of foundations in society and about their overall effectiveness. The payout issue, says William Schambra, director of the Hudson Institute's Bradley Center for Philanthropy and Civic Renewal, is secondary to the larger issue about what philanthropy is doing, what it ought to be doing, and where its resources are going:

> An awful lot of money in the field of philanthropy is wasted. The notion that the big foundations, if they were forced to pay out more money, would pay out more money well is contingent on challenging that larger question, and I don't see anyone really taking that on. There's an assumption that the money leaves the foundation and goes into really good social services or really good charitable work. But an awful lot of that money doesn't go there. From the big foundations that are sitting on top of most of the principal, it goes to these huge expert-driven initiatives that are launched by the foundation, carried out by huge nonprofits, evaluated by university experts, and then celebrated in conferences in Washington to which government officials are invited and listen to how this should be the next model for service delivery. Whether you fund that kind of effort with 5 percent payout or 6 percent payout, it's irrelevant.

Of course, the possibility looms constantly that the federal government will step in and change the rules on foundation spending. Congress seems unlikely, at least in the immediate future, to raise the minimum outright. But a recent U.S. Senate Finance Committee "staff discussion draft" focusing on a variety of nonprofit issues include proposals for curbing compensation for foundation trustees and other insiders, limiting the ability of foundations to count salaries, rent, and other administrative expenses toward payout, and capping spending on travel and hotel accommodations.[6] An upshot of such moves would be to increase the base of foundation assets on which payout rates are calculated —and thus to force an expansion of foundation spending.

The payout issue is on the legislative agenda for several reasons. One is that foundations, along with other parts of the nonprofit world, have been in a glaringly unfavorable spotlight lately. Media reports have pointed to alleged financial and governance abuses at a variety of grantmakers and charities. At the same time, many people question why foundation grants have failed to keep pace with social needs in recent years even as foundation assets have skyrocketed. And the creation of thousands of new foundations, many of them small funds formed by people with no experience in organized philanthropy, has led to concerns that donors are reaping tax benefits for contributions that may not be used efficiently for charitable purposes.

Growing Assets

Indeed, the dimensions of the payout debate are all the more compelling in the context of foundation growth, investment earnings, and grant expenditures. From 1985 through 2003, foundation assets rose 173 percent, after adjusting for inflation, to more than $477 billion, and the number of grantmakers rose 159 percent to more than 66,000 foundations — roughly one grantmaker for every 4,500 U.S. residents —according to the Foundation Center, the principal organization gathering data on grantmaking.

Likewise, from 1985 through 1997, assets among the largest 100 non-operating (grantmaking), private foundations that were included in a Treasury Department panel study and were in business throughout that period —a group that accounted for a third of total foundation assets —more than tripled, to $121 billion, after adjusting for inflation, according to the Internal Revenue Service. Spending for charitable purposes during that period rose at about the same rate, from $1.5 billion to $4.5 billion.[7]

In a new study of how the payout requirement and other tax provisions affect grantmakers, accounting professors Richard Sansing of the Tuck School of Business at Dartmouth College and Robert Yetman of the University of California-Davis found that assets among nearly 3,800 foundations more than doubled in just six years, through fiscal 2000, to $310 billion —an annualized growth rate of 13 percent. The 2000 figure includes the 35-largest non-operating foundations. About 74 percent of the growth was from investment returns (income plus unrealized appreciation) and 21 percent from new donations.[8]

Conformity in Payout Rates

Hand in hand with asset growth has been what many see as a striking conformity in foundation spending around the required minimum —what Harvard researchers Akash Deep and Peter Frumkin call "the five percent solution" in a study of payout behavior that identifies a variety of arguments on either side of higher spending rates.[9] Their study of 290 foundations, including the 100 largest, over 25 years shows that as a group, the foundations had a 7.6 percent nominal annual return on their assets but paid out an average of just under 5 percent of assets.

Of course, many foundations pay out more than the required minimum. Members of the Association of Small Foundations distributed an average of 7.3 percent of their assets in grants alone in 2003, according to the group's latest survey. The median level was 4.9 percent, with half the foundations higher and half lower. The smallest members—those with less than $500,000 in assets —gave the biggest percentage of their assets in grants—an average of 12.4 percent, or a median of 5.4 percent.[10]

Likewise, the Sansing/Yetman study, based on a broader sample than the Deep/Frumkin study, concludes that wide variations exist in foundation payout rates. "The belief that seems to pass for conventional wisdom that all foundations pay out 5 percent is not supported by the data," Mr. Sansing said in an interview. "Lots of foundations pay out more."

However, those paying out more than 5 percent in total qualified distributions tended to be smaller foundations, those with assets growing at a higher-than-average rate, and those that spent more on salaries and other administrative costs. Thus, they were presumably newer foundations with significant money flowing in. The same pattern held true when payout was measured in grants alone, except for the dimension of salaries, which Mr. Sansing said had little correlation with grant expenditures.

In fact, a little more than half of the foundations in the Sansing/Yetman study followed the minimum-distribution requirement to the letter or appeared to use it as a guideline for their spending practices, Mr. Sansing said. Moreover, the foundations that spent at the 5 percent level tended to be larger grantmakers with little new money coming in, he said.

Thus, one can reasonably conclude that the largest grantmakers —those controlling most of the assets held by foundations —are, on average, the most conservative in their spending policies. That point comes through in both the Deep/Frumkin and Sansing/Yetman studies.

While one can point to groups such as members of the Association of Small Foundations for evidence of broader spending, the association represents only a small slice of the foundation pie. It estimated the total assets among its 2,900 member foundations at $48 billion in 2003, only about a tenth of the total wealth held by grantmaking foundations.

Key Philosophical Questions

While the data on foundation spending can be interpreted in various ways, many observers say the discussion about payout ultimately should turn on philosophical questions — questions that all foundation executives, trustees, and donors should weigh often and carefully, in the context of both the larger foundation world and their own organizations:

- What is the proper role of private foundations in a democratic society and in what way is that role distinct from the role of charities? How has my own foundation succeeded or failed at fulfilling that role?

- In what way does the quality of leadership by foundation executives, trustees, and donors affect the way payout policies are shaped and perceived? Are leaders at my foundation willing to step forward with a well-conceived agenda for payout, or are they simply following the herd in shaping their distribution policies?

- Should foundations last in perpetuity? If my foundation seeks perpetuity, what is the rationale?

Perhaps the most fundamental questions are those involving perpetuity, a smoldering issue that no amount of economic analysis has managed to extinguish. "There are always going to be competing studies about what the right payout number is," said Mark Kramer, founder and managing director of the Foundation Strategy Group in Boston and a 20-year veteran of the grantmaking world as a trustee of family foundations, researcher, and consultant. "But is perpetuity the right goal? Until you know what social purpose foundations serve, you don't know whether they should last in perpetuity. And the payout rate is only about perpetuity."

Mr. Kramer, whose organization helps grantmakers measure and improve their performance, said many foundations would be more effective if they chose a limited life. That, he said, would "force foundations to think in a more disciplined or constructive way about what they are trying to achieve, and that would likely lead to more social impact."

Mr. Katz, the Princeton scholar, calls the often-bitter squabble over payout a "proxy" for a more fundamental discussion about "whether perpetuities are an appropriate method for wealthy people to use to pursue the public good." Nonprofit leaders have failed to undertake that discussion in a meaningful way, he said. Yet Mr. Katz said he firmly favors perpetuity for foundations because it maximizes their chances of succeeding in improving society without being tied to the fleeting passions and interests of the day.

Still, one can wonder how many foundations have adopted perpetuity —and a minimum payout rate to ensure it —without thinking deliberately about how and why such an aim dovetails with their goals. A 2004 Foundation Center study found that more than 67 percent of responding independent foundations expected to exist in perpetuity, while about 9 percent did not. The rest were undecided.[11] It is not clear what proportion of the majority were compelled by legal stipulations to stay in business forever.

A Pattern of Behavior

In their study, Mr. Deep and Mr. Frumkin noted that the weight of tradition and a tendency to avoid risk have kept many foundations' spending rates frozen.

"The 'five percent solution' has been endorsed by large numbers of foundation managers and trustees through years of practice," they noted. "Deviating from this established pattern of behavior exposes foundation managers to considerable risk, should the additional funds they wish to expend not achieve their intended purpose. This is particularly problematic given the rise in professional careers in the field of philanthropy over the past three decades and the desire for advancement that accompanies professionalization. For the foundation executive, staying within the confines of the five-percent payout is simply the safest and surest course of action."

For trustees —the people who ultimately determine a foundation's payout strategy —the inclination to play it safe is intertwined with the concepts of fiduciary duty: to pay close attention to the affairs of the foundation, exercise care and loyalty in governance, follow legal requirements, and so on. But sometimes the propensity among trustees to play it safe is compounded by a tendency to focus on the financial side of a foundation's dealings rather than the program side, and to consider their chief duty as one of conserving assets rather than disbursing them. That often happens because many trustees come from the for-profit business world and put a premium on financial performance.

"There's an odd thing where the purpose of the foundation, which is grantmaking, is not always considered by the trustees to be their primary fiduciary responsibility," said Teresa Odendahl, Waldemar A. Nielsen Visiting Professor of Philanthropy at the Georgetown

Public Policy Institute and chair of the National Committee for Responsive Philanthropy, a staunch advocate of higher payout. "When they think about fiduciary responsibility, they think about protecting their assets."

In many foundations, echoed Mr. Schambra of the Hudson Institute, "you have directors who are sitting on the board, and the part they are puzzled by is the grantmaking side. The part they really get is the financial side —the corpus-preserving and -enhancing side. Pretty soon what you find out is that the foundation comes to view preserving the corpus as an end in itself. For the guys who are running the foundation —the board, finally —their prestige, their personal financial expertise, everything is engaged in maintaining a corpus as great as possible, and the grantmaking side becomes less important."

The obvious solution to this and many other problems surrounding foundation spending is for executives, trustees, and donors to demonstrate disciplined leadership and deliberate thinking on questions of perpetuity, intergenerational equity, and social responsibility.

"Strategy is about aligning your activities with your goals," said Mr. Kramer. "The rate at which you spend your money should depend on the problems you are trying to tackle and the strategy you're trying to use. One would hope to see foundations with many different payout rates driven by the objectives they're trying to achieve."

Ms. Brody, the law professor, added that "leadership is not what can be mandated. Foundations should be encouraged to think about what they're saving for and whether they are spending a certain amount because it's the path of least resistance —what is required." She continued: "I'm not saying everyone should go crazy and spend down all their endowments, but I would like each organization to think about it. I would like that to be part of what their mission is as a foundation —not just *what* they're spending their money on, but *when* they're spending their money."

II: History

The debate over payout may seem like a product of recent origin, but its roots go back to the 17th century.

The seeds were planted in English common law[12], which forms the basis of American law. The English looked with disfavor at perpetual trusts (the antecedents of foundations) or any other means by which land —the main source of wealth —could be passed to heirs or charity without the payment of taxes.[13] Those ideas flowed from England to the Colonies, instilling in the American psyche a deep suspicion of dynasties built on inherited riches. Many early American thinkers rejected the concentration of assets in the hands of a few and, in some states, the idea that the "dead hand" of the departed should continue to control assets. "The earth belongs… to the living," Thomas Jefferson wrote, and "the dead have neither powers nor rights over it."[14]

The formation of big private foundations by oil baron John D. Rockefeller, steel magnate Andrew Carnegie, and others at the beginning of the 20th century heightened many Americans' discomfort with perpetual pools of wealth and their potential for abuse. In 1916, in the waning days of the Progressive Era, the congressionally appointed Walsh Commission examined the social and economic influence of big foundations and proposed a ban on their perpetuity. Congress did not act. But criticism of perpetuity persisted, even coming under fire from one of the era's wealthiest philanthropists.

Julius Rosenwald built a fortune as president of the Sears, Roebuck & Co. and used it to form a major foundation focusing on social conditions. In 1929, he wrote:

> I am opposed to the principle of storing up large sums of money for philanthropic uses centuries hence for two reasons. First, it directly implies a certain lack of confidence with regard to the future, which I do not share. I feel confident that the generations that will follow us will be every bit as humane and enlightened, energetic and able, as we are, and that the needs of the future can safely be left to be met by the generations of the future. Second, I am against any program that would inject the great fortunes of today into the affairs of the nation five hundred or a thousand years hence.[15]

A year earlier, Mr. Rosenwald had directed his foundation to spend all its assets and go out of business within 25 years of his death. It did just that in 1948, beating the deadline by nine years.

In the ensuing decades, the focus of debate shifted from foundation perpetuity to foundation impropriety, culminating in a major overhaul of the laws governing private foundations in 1969.[16]

Concerns About Abuse

For years, in the absence of a required payout rate, concern had been brewing that some were using foundations as means to enrich themselves and their families, dodge taxes on private and corporate wealth, and maintain control of assets while claiming to give them away for charitable uses. President Harry S. Truman charged in 1950 that foundations were being employed "as a cloak for speculative business ventures," leading Congress to change the tax code in an attempt to stop some abuses.

During the post-war economic boom, the number of private foundations, with their allure as tax shelters, continued to grow rapidly. By the early 1960s, they were growing at the rate of 1,200 annually, and federal lawmakers and Treasury officials were becoming increasingly concerned about their exploitation. U.S. Representative Wright Patman, a populist Democrat from Texas, began a crusade against foundations in 1961, citing what he considered their use as elitist tools for personal power and tax avoidance. What especially worried Mr. Patman was foundations' power to manipulate the securities markets and use assets to gain control of corporations?[17] Others, including Senator Albert Gore Sr. of Tennessee, also engaged in foundation scrutiny.

In 1964, the U.S. Senate Finance Committee asked the Treasury Department to conduct a full-scale investigation of foundations and recommend legislation to deal with the problems it uncovered. A Treasury report issued in 1965 "rejected the contentions…that foundations had become a disproportionately large share of our national economy and that they represented dangerous concentrations of uncontrolled economic and social power," Thomas A. Troyer, a Washington lawyer who helped to draft the Treasury report as a young attorney in the department's Office of Tax Policy, wrote a few years ago. "It consequently rejected calls for the imposition of a time limit on the lives of all private foundations." Still, Mr. Troyer wrote, "Treasury found serious abuses among a minority of foundations, and it recommended legislation to deal with them. The core proposals were a general interdiction of self-dealing transactions, a requirement for annual foundation payouts for charitable purposes, and restrictions on business holdings."

The Case for a Minimum-Distribution Requirement

In making its case for mandatory annual distributions, the Treasury expressed concern about accumulated assets in the hands of foundations. Treasury pointed out "that the assumption underlying the charitable deduction —that loss of tax revenues will be offset by use of the contributed funds [to] advance the public welfare —loses force when private foundations which do not conduct active charitable programs are permitted to retain both the contribution and the income produced by it for indefinitely long periods," Mr. Troyer wrote.[18]

The Treasury recommended a minimum payout equal to the greater of two markers: a foundation's realized investment income (for example, interest and dividends but not capital gains) or a 3-to-3.5-percent share of its investment assets. Treasury based that percentage target on the returns then being earned on college and university endowments, Mr. Troyer said in an interview.

Some in the Senate called for a limit on the lives of foundations, with proposals ranging from 25 to 40 years, but Congress ultimately declined to impose term limits. Still, it required grantmakers to distribute annually a portion of their wealth to charity in exchange for their favorable tax treatment. The Tax Reform Act of 1969 set the minimum payout rate as the greater of realized income or 6 percent[19] of investment assets, with Treasury required to adjust the latter annually based on the previous calendar year's money rates and investment yields.[20]

The idea of imposing a minimum payout requirement had broad support in policy and charity circles. But in the 1970s the economic climate shifted. In 1973-1974, the stock market crashed and inflation skyrocketed, eating away at the purchasing power of foundation grants. In 1976, the government announced that the payout rate on foundation assets would climb to 6.75 percent according to the legal formula. That was a level well above what the Treasury Department had recommended and even what federal lawmakers envisioned in 1969. In response, Congress did away with its mandate that Treasury vary the rate and instead set it at a constant 5 percent. It retained the "greater of" provision pertaining to foundation investment income, however.

During that era's unprecedented period of "stagflation," when interest rates and inflation were high and economic growth slow, many foundations worried that their buying power would quickly erode if they had to distribute their income on interest-bearing investments. In a 1976 analysis of the payout law[21], Eugene Steuerle argued that this approach penalized foundations that invested in bonds and forced them to adjust their portfolios for arbitrary reasons. In 1981, with foundations under increasing pressure to adopt low-yield investment approaches, Congress dropped the income standard and kept the payout rate at 5 percent of foundations' net investment assets—the policy that exists today.

Weighing the Payout Rule's Impact

From the moment Congress passed the Tax Reform Act of 1969, nonprofit scholars, practitioners, and policy analysts have scrutinized its approach and impact. Among the most prominent analyses was the 1976 study by Mr. Steuerle, who was involved in shaping adjustments to the payout law in the years after its enactment. Mr. Steuerle's paper remains relevant today, in part for its caution against significant year-to-year fluctuations in required distributions and its explanation of the effects on grantees when payout trends track national economic cycles too closely. Those problems became obvious in the late 1990s, when foundations flush with stock-market gains were required to distribute huge sums in grants, only to have their assets —and payout amounts —shrink after Wall Street hit the skids in 2001. A quarter century ago, Mr. Steuerle pointed out the dangers of such swings:

"A sizable fluctuation in required distributions … may lead to suboptimal planning on the part of the foundations," Mr. Steuerle wrote. "Many projects need substantial lead time to develop. Sudden increases in the value of a foundation's portfolio may require distributions for which the planning is inadequate."

Further, if payout trends coincide with a short-term investment-return cycle, he cautioned, foundations would tend to give more money when grantees may need it least, and reduce giving when the economy is weak and grantees need money the most. It would be better if foundation payout went up when the investment markets were weak and eased back when the economic climate was strong, he wrote. "The need for foundation support may be greatest…when the economy is in a recession," he noted.[22]

Even if social needs are equal from year to year, one can ask whether a payout regimen that leads to significant annual fluctuations in foundation giving is the most efficient that can be devised from a planning perspective. In his paper, Mr. Steuerle said the payout requirement "should be related to the long-term real rate of return on foundation investments," with the distribution rate recalculated every few years and applied equally to all foundations regardless of their portfolio compositions.

Mr. Steuerle's paper also analyzed the effects of the payout requirement on the potential growth and size of the charitable sector, taking into account the relationship among the required distribution rate, the rate of new money flowing into the foundation world, and the rate of return that foundations earn on their assets.

Consider, for example, a foundation that earns a 6 percent real (or inflation-adjusted) return on its assets, pays out 5 percent in real terms annually, and receives no new money. It would grow in real terms by only 1 percentage point —and probably decline in size relative to the economy and to some new foundations. If the foundation's payout rate were greater than its real rate of return, then the foundation would decline in real value toward zero, a process that could take many decades. Still, the loss of that individual foundation, Mr. Steuerle noted, would not mean that the foundation world as a whole would necessarily shrink. That is because new money —and new foundations —are likely to take the place of those that disappear.

Thus, he noted, it is important that the empirical issue of what rates of return individual foundations receive on their portfolios be separated from the policy question of what is the most appropriate minimum payout rate. Issues of whether foundations should be allowed to exist in perpetuity or be limited in their life spans, asset growth, or relative status cannot be answered through empirical data, but only through careful policy deliberation, he suggested.

Yet, as the law on payout has evolved over the past few decades, the debate has shifted toward percentages of assets distributed and such specific issues as the use of historical dollar value as a baseline in calculating endowment expenditures.[23] As important as those issues may be, some scholars question whether the focus of the debate needs to be redirected.

A New Proposal on Payout

In a new study[24], Stefan Toepler, an assistant professor of nonprofit studies at George Mason University, suggests that "a discussion of the actual *intended* effects of the payout requirement is virtually absent from the debate" and that the Tax Reform Act of 1969 "continues to escape any serious analytic scrutiny." The 1969 law "was grounded in the fear or suspicion that philanthropic foundations were widely misused for economic rather than charitable purposes," he notes. But current debates over the "mechanics" of payout —whether, for example, the distribution rate should be 5 percent or 6 percent or whether administrative expenses should count toward payout —are occurring "with little apparent reference to the requirement's underlying objectives. Accordingly, the discussion has become somewhat of a free-for-all where actuarial hypotheses are pitched against political and ideological desirabilities. Lost in the melee is the original intent and purpose of the requirement."

The 1969 law's chief aim "was to prevent abuse and force foundations to provide a minimum payback to the public for the tax privileges they receive" —the same goal and justification that informs European policy on foundation spending, writes Mr. Toepler, who also is affiliated with the Maecenata Institute for Philanthropy and Civil Society at the Humboldt University of Berlin, in Germany. Hypothetically applying German rules to Ford

Foundation data, Mr. Toepler proposes introducing time limits to the payout requirement — in essence dropping the payout requirement after foundations have repaid the "debt" of favorable tax treatment.

"Enforcing minimum payouts until 'tax investments' are recouped and freeing foundations from these regulations thereafter would satisfy both (T)reasury and managerial efficiency considerations," he writes. "Moreover, if the payout requirement were limited in such a way, higher than current payout levels might be less controversial, because foundations could reduce spending and recoup any purchasing power losses after their overall payout obligation is fulfilled. This would then constitute a compromise that would also give some ground to the values on both opposing sides of the debate: providing more money for present-day charity without taking too much away from future needs."

III: Overhead and Administrative Expenses

The payout issue has remained explosive in recent years in part because of details of questionable foundation spending disclosed in the popular press. In a series of articles, the *Boston Globe* wrote of outlays for jet aircraft and wedding festivities, gold-plated retirement plans, and break-the-bank trustee fees. The *San Jose Mercury News* disclosed that the James Irvine Foundation in San Francisco crafted a pay and retirement plan for its former president that added up to more than $700,000. The *Chronicle of Philanthropy* reported that foundation-like entities called supporting organizations, along with other nonprofit groups, made loans totaling millions of dollars to their top officials.

Few would argue that such practices are the norm. But the stories underscore larger questions about how foundations should account for so-called administrative expenses,[25] or overhead: What constitutes legitimate overhead? Should grantmakers be allowed to credit such expenses against the minimum 5 percent of assets they are required to pay out for charitable purposes? What would happen if some or all administrative expenses could no longer be counted toward the minimum distribution?

Under current law, a foundation can include in its payout calculation such expenses as salaries, rent, travel and meeting costs, excise-tax and unrelated-business income tax payments (see IV: Government Oversight, Self-Regulation, and Excise Taxes), grant-monitoring outlays, and other "necessary and reasonable administrative expenses" related to the organization's charitable purpose.

Critics argue that reducing or eliminating administrative expenses from the payout calculation would free up billions of additional dollars for charities. That is especially important, they say, because of cutbacks in government support for social services in recent years. In addition, they contend that foundations would operate far more efficiently if they weren't able to count overhead in meeting the payout requirement. Questionable spending practices like those outlined in the press in recent years would be less likely to occur, they say.

But those who believe overhead expenses should continue to be counted toward the minimum payout requirement argue that excluding them would harm foundations —and ultimately the charities they support. If foundations couldn't count administrative costs, they contend, grantmakers would be forced to distribute substantially more of their assets each year than they do now —a back-door hike in the payout rate that could erode their endowments and eventually force them out of business.

Moreover, those who favor counting overhead toward payout argue that if the expenses are disallowed, foundations might seek to reduce their administrative costs by cutting back on efforts to screen grant applications, monitor grantees' efficiency, and provide guidance to grant recipients. That, they contend, especially could hurt fledgling charities and those with innovative programs. Foundations would be inclined to steer money more to "safe" grantees with established track records than to "risky" grantees with promising but untested programs, they say.

Many foundation experts believe that targeting administrative costs as a way to increase payout is a bad idea. Mark Kramer, the foundation consultant and researcher, is among them. "If a foundation is really creating value, that comes through things its staff does, and it often comes through the non-grantmaking activities. When we look at the performance of a foundation, we don't distinguish between grants and operating expenses. We say, 'You've got X dollars, and how much are you achieving with those dollars?' I don't care if 90 percent of it is operating expenses and 10 percent is grants or vice versa if it leads to social impact."

A tendency to minimize overhead can lead to absurd results, Mr. Kramer said. "If you just funded every third grant request that came in, you wouldn't have any overhead, but you wouldn't be doing any selection either, and you wouldn't be creating any value."

The Need for Operating Support

Joel Orosz, Distinguished Professor of Philanthropic Studies at Grand Valley State University, said much of the tension over payout could be defused if foundations did more to help grantees pay for their own overhead and operating expenses —so-called capacity grants and operating support to help charities cover such expenses as office space, computers, and clerical work and to help them expand small, innovative programs into large-scale efforts. A recent Foundation Center survey of independent, corporate, and community foundations found that 68 percent of respondents said they provided general operating support to grantees.[26] Still, many foundations have resisted making such grants —or at least resisted allocating a big enough share of their grant dollars to make a major difference, especially in times of slow economic growth.

"The fact is, nonprofits have been starved for years by program grants that don't include adequate provision for legitimate overhead for running the programs," Mr. Orosz said. "Part of the reason nonprofits are clamoring for increased payout is that they just need more money to operate. One crude way of getting it is to force foundations to pay more."

Still, Mr. Orosz acknowledged the dangers foundations face in making such grants. "The fear in the foundation world has always been that once you open that gate even a little bit, the hordes will come pouring in because every nonprofit has overhead needs. And that's exacerbated by donors and pundits who say foundations should be able to demonstrate real, countable outcomes and substantial societal impact. If you're paying folks to keep the lights on, that outcome is not terribly exciting."

While the question of operating support is important, the broader issue of treating administrative expenses as part of the minimum-distribution requirement is essential to the payout debate. Sally Osberg, CEO of the Skoll Foundation, which was created in 2002 by eBay executive Jeffrey S. Skoll (see Appendix: Selected Examples of Approaches to Payout), said the idea of excluding such expenses from payout "is another one of those wedges that says we can't have a relationship with the frontline nonprofits" that the grantmaker supports.

Skoll's grantmaking focuses on creating systemic change by supporting "social entrepreneurs," and Ms. Osberg describes it as a "highly interactive" process between the foundation and the groups it supports. "We build communities of our grantees, we put them together with consultants, we do capacity grants. That's part of our management expense that does indeed figure into our calculations [of overhead], and it's added value," she said. She also noted that Skoll sponsors an "online community" called Social Edge that allows philanthropists, social entrepreneurs, and charity employees to communicate and exchange ideas and resources.

Separating administrative costs from grant distribution would send a signal that goes far beyond dollars and cents, Ms. Osberg suggested. "It sends the message that the work we're doing with foundations, the relationships we're building with grantees, is not of value in the enterprise we're all engaged in, which is creating social change."

But Jeff Krehely, deputy director of the National Committee for Responsive Philanthropy (NCRP), said that a grant and an administrative expense such as salaries "shouldn't be legally and financially equivalent" when viewed in the context of payout. And while NCRP wants administrative costs excluded from payout, that doesn't mean foundations should shirk their due diligence in assessing grant requests or that they shouldn't build relationships with grantees, he said. "Almost all foundations have more than enough assets" to do those things without counting administrative costs against grant spending, Mr. Krehely contended. "It's not an either/or position."

The Blunt/Ford Proposal

The stark lines of division on the administrative-expense issue became clear in 2003 when U.S. representatives Roy Blunt, a Missouri Republican, and Harold Ford Jr., a Tennessee Democrat, added to an omnibus charity bill a provision to exclude administrative costs from foundation payout. The bill, H.R. 7, or the Charitable Giving Act of 2003, did not become law, even after compromise language was crafted to allow some administrative expenses in payout. But the debate over the Blunt/Ford proposal helped to define where various groups stand on the payout issue.

The National Committee for Responsive Philanthropy endorsed the proposal to disallow administrative expenses from payout as "modest and reasonable." NCRP concluded that by excluding such expenses, foundations could distribute an additional $4.3 billion annually to charities.[27] It based that estimate on data from the Internal Revenue Service, which identified $2 billion in charity-related operating and administrative costs in 1999, plus additional data from the National Center for Charitable Statistics at the Urban Institute.

Responses quickly emerged from the Council on Foundations and the Foundation Center, which collects and analyzes information about grantmakers. The Foundation Center declared NCRP's figure to be "grossly overstated." It estimated the Blunt/Ford provision "would likely result in increased grantmaking totaling well under half of the $4.3 billion estimate."[28]

NCRP subsequently scaled back its estimate, saying that excluding administrative expenses from payout calculations could provide "up to $3.2 billion" in additional grants for charities. NCRP continues to call the idea of excluding overhead from payout "a balanced and reasonable tax reform that would help America's charities with billions of dollars in new grants while sustaining foundations for the long haul and encouraging foundation efficiency."[29]

The Chronicle of Philanthropy concluded shortly before NCRP and the Foundation Center released their figures that the Blunt/Ford proposal could have generated more than $370 million for charities in 2001 from the 25 richest foundations, or $1.2 billion for the years 1999-2001.[30]

Many foundation executives bristled at Washington's attempt to exclude overhead from payout. "There's a tendency to think of administrative costs as a waste," says Paul Brest, president of the William and Flora Hewlett Foundation. "But for a foundation that is serious about grantmaking, administrative costs —which are largely personnel —are what make a foundation successful. Imagine Congress saying it could not have any administrative costs —suppose you pay the congressmen but they can't have any staff."

Likewise, the Council on Foundations, the chief industry trade group for grantmakers, fought aggressively against the Blunt/Ford proposal, along with Independent Sector and a group of 18 big foundations, including Hewlett, the Ford Foundation and the Robert Wood Johnson Foundation. The foundation group hired former Republican Congressman Bill Paxon to lobby against the measure.[31]

Dorothy Ridings, the Council on Foundation's chief executive, declared at a symposium that excluding overhead from payout would be "like using a baseball bat to kill a bee." While acknowledging "problems of excess in the foundation world," Ms. Ridings said the law "already disallows administrative expenses that are unreasonable and unnecessary." However, she suggested, enforcement of such laws has been lax because the IRS is both under-financed and "it appears . . . under-motivated to provide the oversight on which our sector's public confidence relies."

Ms. Ridings said that for many foundations, excluding overhead from payout "would threaten both the quality of their grantmaking and their ability to exist in perpetuity if their donors so wished. . . . (S)ome of the most important work done by private foundations is through their work that's categorized as an administrative expense. I'm talking about program evaluation. I'm talking about ways to ensure effectiveness. I'm talking about bringing grantees together to discuss best practices and communication with the public about the issues and the programs that the foundation is interested in. I'm talking about management training for grantee staff so they can do their own work more effectively."[32]

Rick Cohen, executive director of the National Committee for Responsive Philanthropy, spoke at the same symposium in favor of the overhead exclusion. Leaving out administrative and operating costs from the minimum payout requirement would increase total foundation payout by only 0.4 percent, Mr. Cohen argued. Moreover, he said, NCRP studies of large foundations indicate that many pay out less than 5 percent in grants annually, and some 4 percent. "There's a substantial element of room for the large foundations, in particular, to be able to put more money into grantmaking," he said.

Mr. Cohen also suggested that private foundations have an obligation to help charities, especially so-called community-based charities that are experiencing cutbacks in donations, government revenue, and foundation grants at a time when there is an upsurge in demand for services because of the poor economy.

"The first question is…, what's the obligation of institutions of tax-exempt wealth to share their riches with America's nonprofit sector?" he asked. "How do you access the almost $500 billion in assets that are out there, to really mobilize and support the nonprofits that are doing great work on the ground?"[33]

Overhead and the Senate Discussion Draft

While H.R. 7 and its proposal on administrative expenses died with the 108th Congress, the debate on how overhead should be treated in payout calculations remains very much alive. It has come up again with release of the Senate Finance Committee's staff discussion draft on oversight of nonprofit organizations.[34] The draft proposes a number of controversial ideas aimed at improving the governance of nonprofit groups and curbing abusive practices.

For example, one proposal would require a grantmaker whose administrative costs add up to more than 10 percent of its total expenses to file supporting documents with the Internal Revenue Service. The IRS would review the expenses for a fee —paid by the foundation — to determine if they were "reasonable and necessary" for purposes of the minimum payout rate. Administrative costs above 35 percent of a foundation's total expenses would not count toward the 5 percent minimum-payout requirement.

Another proposal in the draft would limit expenditures for travel, meals, and hotel accommodations to the federal government's per diem rate or an alternative nonprofit corporate rate, perhaps published by the IRS. In addition, the draft contains proposals to curb excessive salaries of foundation officials and staff members, and to limit or outlaw payments to trustees.

Trustee Fees and the Payout Calculus

The issue of trustee fees is an especially sore subject among those who want to see payout rates rise and administrative expenses excluded from payout calculations. A study by Pablo Eisenberg, of Georgetown University, and two colleagues concluded that the 238 foundations they surveyed paid a total of $44.9 million in trustee fees in 1998. Most of the money went to individual board members. Another $13.8 million went to bank trustees at 25 foundations. Roughly three-fourths of the foundations surveyed were among the nation's largest. The rest were groups with assets of about $226 million or less. The researchers acknowledged that "the smaller foundations, in general, were much less responsive to our inquiries than the larger foundations." Of the large organizations, 113 foundations, or 64 percent, provided trustee fees, while 49 of the small organizations, or 79 percent of that group, did so.

With few exceptions, people who serve on boards of charities receive no compensation, though they can be reimbursed for certain expenses, and many are from low- and middle-income backgrounds, the study's authors noted. "By contrast, the overwhelming number of foundation trustees are either wealthy or highly paid professionals who can easily afford to volunteer their services to foundations free of charge." The authors recommended that trustee fees be limited to no more than $8,000 per board member annually and that foundations be barred from counting trustee fees as part of payout.[35]

Besides excluding administrative expenses from payout or limiting them, Congress could also approach the issue of overhead in another way: by allowing some expenses to count toward payout and others not.

That idea was proposed in 2003 by Sen. Kay Bailey Hutchison, a Republican from Texas, and later incorporated into the compromise version of the failed Blunt/Ford bill. The approach would have excluded from the minimum payout calculation all but "reasonable and necessary administrative expenses which are directly attributable to direct charitable activities, grant-selection activities, grant-monitoring and –administration activities," legal compliance, or advancing a foundation's public accountability. It also would have excluded expenses for first-class domestic air travel and any travel outside the United States from counting toward payout.[36]

While counting only "reasonable and necessary" expenses toward payout may have a certain logic to it, however, many observers say the itemization approach is flawed, partly because enforcement would be difficult and partly because compliance would wind up costing foundations money.

"We don't think there is any way to enforce that," says Jeff Krehely of NCRP. "Who is going to set up those definitions, and who at the IRS is going to actually parse that out?"

Caroline Williams, chief financial and investment officer at the Nathan Cummings Foundation, said it would be an "administrative nightmare" to allow some administrative expenses related to charitable purposes but not others.

One problematic proposal in the Senate staff discussion draft is the limitation of air fares and hotel charges to the federal per diem rate, she said. To comply, she said, Nathan Cummings would have to hire a full-time person who did nothing but make travel arrangements —a move that would end up adding to the foundation's overhead.

IV: Government Oversight, Self-Regulation, and Excise Taxes

"[W]e've been pummeled by two years of revelations about a proportionally few —but a very visible few —in the charitable sector who have lived lavishly on charitable dollars and engaged in acts of self-dealing that would make Alexis de Toqueville re-examine his admiration of American altruism," Dorothy Ridings told a meeting of state charity officials last fall.[37]

As Ms. Ridings' comment suggests, even the most ardent defenders of private foundations concede that spending abuses have marred the image of grantmakers. Yet questions remain: How much responsibility does the foundation world itself bear for the sins of the "proportionally few"? How much should foundations look to government to police their spending?

In the wake of negative news coverage of the grantmaking world, the Council on Foundations has taken voluntary steps to root out abusers in its midst. It recently began a two-year effort to educate grantmakers on legal requirements and help them develop ethical standards for grantmaking. Commenting on the effort, Emmett Carson, the Council's board chairman, said it was "imperative" that the philanthropic field "reaffirm and demonstrate its integrity."

"We must use increased scrutiny and new benchmarks to look at ourselves, not just to others, for the conscience and diligence that is incumbent on maintaining the public trust," said Mr. Carson, the CEO of the Minneapolis Foundation.[38]

Nonetheless, looking to others —especially federal and state regulators —will likely intensify as foundations and other nonprofit groups continue to grow larger, more numerous, more complex and sophisticated, and, in some cases, more prone to engage in inappropriate activity. And as government regulation plays a bigger role in foundation oversight, one issue will be front and center: the excise tax that foundations pay on their net investment income.

Background of the Excise Tax

The tax has a long and controversial history. Contained in the 1969 tax legislation that imposed the minimum-payout requirement was a provision imposing an excise tax of 4 percent on investment income earned by private foundations.[39] In 1978, Congress cut the excise tax in half, to 2 percent, and in 1984 it adopted the 1- and 2-percent two-level approach that exists today.

Under the original statute, revenue from the tax was earmarked for government oversight of philanthropy, but the system never actually worked that way. In recent years the tax payments have far exceeded the budget for the IRS's Exempt Organizations Division, the chief enforcement agency for the nonprofit field. Yet the money has been diverted to the Treasury for general uses, while the IRS has, by all accounts, lacked the appropriate resources to do its oversight job properly.

IRS Commissioner Mark W. Everson told the Senate Finance Committee last June that the Service's "audit coverage has fallen to historically low levels, compromising our ability to maintain an effective enforcement presence in the exempt organizations community."[40] The number of IRS audits of private foundations declined from 1,200 in 1990 to 191 in 1999, according to the Council on Foundations.[41]

Another issue of concern related to the excise tax is its two-level system that sometimes has perverse consequences for foundation payout. The dual approach punishes foundations for making larger-than-usual distributions in one year by raising their tax rate over the next five years if they don't sustain their giving at the higher level. The tax, "at either 1 or 2 percent of income, encourages foundations to minimize giving," policy analysts Elizabeth Boris and Mr. Steuerle, both of the Urban Institute, have concluded.[42]

In their study on payout, Richard Sansing and Robert Yetman offer an example of how the excise tax works. "Suppose over the preceding five years the foundation spent on average 6 percent of its investment assets in qualifying distributions," they write. "This year the foundation has investment assets of $100 million and net investment income of $8 million. If this year's qualifying distributions are less than $6,080,000, then its tax is $160,000; if qualifying distributions are $6,080,000 or more, then its tax is $80,000."

Their study noted a "severe 'cliff effect' " in the excise-tax formula because "falling even one dollar short of the distribution threshold causes the excise tax to double." In the fiscal year ending August 31, 1999, the Eugene McDermott Foundation fell less than $5,000 short of the threshold, and its excise tax rose by more than $150,000, the study found.

The Senate staff discussion draft appears to make a small concession to the relationship between the excise tax and levels of grantmaking. One proposal would excuse foundations from paying the tax for any year in which they distributed more than 12 percent of the return on their investment assets in grants alone. But the proposal makes no mention of what tax rate those foundations would pay in the ensuing years.

A Point of Agreement

With so much at stake in curbing abuses and encouraging more foundation giving, a consensus seems to have emerged among grantmakers, watchdog groups, and trade associations alike that fixing the excise tax should be a priority for Congress. An obvious remedy would be to jettison the two-tier approach in favor of a flat 1 percent tax and to use the excise revenue as it was originally intended: to improve IRS oversight of nonprofit organizations.

The Council on Foundations favors repeal of the tax. But absent that, it wants to see the tax flattened to 1 percent and the money used for oversight, a spokesman said. The National Committee for Responsive Philanthropy, frequently at odds with the Council on matters of foundation policy, also wants the tax at a steady 1 percent and the money used for regulation.

"Maybe if there were more oversight and enforcement, it could help to weed out the bad actors and provide some additional guidance overall," said Diane Canova, vice president for government relations and public policy for the Council on Foundations. And said Mr. Krehely, the deputy director of NCRP: "Because of the number of scandals, there's a huge need for more resources for the government to provide oversight."

But some observers suggest that foundations are placing too much emphasis on reducing the excise tax. Ralph Smith, senior vice president of the Annie E. Casey Foundation, which takes no formal position on the tax, said he is surprised that the issue has taken on such importance in the grantmaking field. "It seems like a very technical conversation that's unrelated to mission," he said.

If the foundation field takes a "balance-sheet, bottom-line" approach to the excise tax and payout issues generally, it risks failing to demonstrate that it can find effective ways to supervise itself, Mr. Smith said. "We need to begin to imagine how we introduce meaningful self-regulation into the field. There just are not enough proposals on the table, so what we do is default to the IRS."

Mr. Smith said his comments are "not a criticism as much as a critique" of the foundation field. While he said it needs to take on the key attributes of a professional culture —being responsible for disciplining members, setting standards, developing legal and technical skills of members —he is quick to add that "there are quite understandable reasons we haven't done it so far." He continued:

> Philanthropy is very much a sum total of a lot of individual decisions by well-intentioned individuals who have taken their private wealth and tried to do things for the public good. How do you create an open economy where they feel they can do that on the one hand, but on the other have standards and be responsive to the needs of good stewardship? We need to figure out how to do the hard work of building a self-regulatory system that doesn't discourage philanthropy.

Mr. Smith is not alone in his appeal for greater self-determination. But the devil of such ideas is in the details, and many people in the nonprofit world are watching closely for the details.

Consider a proposal in the Senate staff discussion draft to use excise-tax proceeds to subsidize nonprofit groups that educate other tax-exempt groups on "best practices" and, more broadly, help charities meet accrediting standards and disseminate information about the nonprofit field. Adam Meyerson, president of the Philanthropy Roundtable, an association of more than 600 donors, foundation officials, and others, told the Finance Committee that such a move, "though well-intentioned, may in the long run cause irreparable harm to the philanthropic sector."

"It is inappropriate for the philanthropic sector to turn to government to raise resources for its own self-improvement," he stated. "Philanthropists and the organizations that assist them have the resources to raise this money themselves. . . . Turning to government for financial help would be corrupting to the spirit of independence and voluntary initiative that animates philanthropy at its best."[43]

Some experts believe that keeping the tax in place, whether at 1 percent or 2 percent, without using the money for nonprofit oversight could eventually have stiff consequences for groups that currently are not taxed on their investment income —heavily endowed universities and community foundations, as prime examples.

"If the tax is retained now that it no longer can be justified as a fee for funding IRS oversight of exempt organizations," wrote Catherine E. Livingston, chief of the Executive Compensation Branch in the IRS's Office of the Associate Chief Counsel and former Treasury official, "a tacit policy will be adopted, making it appropriate to demand that charitable organizations contribute to the general costs of government by paying income taxes."[44]

V: The Studies

Stanley Katz, the Princeton University professor and longtime researcher and educator in the nonprofit field, turns to Aristotle when he thinks about the debate over the required minimum payout rate.

"Aristotle said, 'Everything that is necessary is necessary upon some hypothesis,'" Mr. Katz said. "If you tell me 5 percent is necessary, then you have to tell me what your hypothesis is. The same is true for 6 percent, 7 percent, or any other payout rate," he said. "Either your hypothesis is that you want to defend the idea of perpetuity, or you want foundations to be more accountable, or something else. But those are distinct arguments, and they rest on distinct assumptions."

Yet nuanced thinking about payout has not always occurred in the foundation field. In their study of payout, Akash Deep and Peter Frumkin found what they call "a remarkable convergence in foundation payout behavior" around the 5 percent minimum.

"There is no answer on the 'right' payout rate —there really cannot be one answer," Mr. Frumkin said in an interview. "It has to relate to the [foundation's] mission. The debate has been about 'higher or lower.' The real debate should be about pluralism versus unanimity."

Many factors account for the lack of greater diversity in foundation payout rates. Perhaps none is more striking than the influence of a small number of economic studies sponsored by the foundation field. Those studies have concluded that if a grantmaker wants to sustain its purchasing power indefinitely, it should hold its spending close to the legal minimum. The studies also have come to the inevitable conclusion that by holding back on giving today, foundations will have more resources to give tomorrow.

Two points are important about those studies, however: First, their data have been interpreted and critiqued in a number of ways, so they are not viewed as gospel by the entire nonprofit world. Second, other studies —including a prominent one sponsored by advocates of a higher minimum payout rate —have reached quite different conclusions.

"Dueling studies" is how the Council on Foundations described the situation a few years ago. "Both sides in the payout debate come armed with studies to back up their points of view," the Council acknowledged, even though it puts its faith in research that supports the current 5 percent rule. "The studies sometimes defy direct comparison because of differing methodologies, definitions and assumptions."[45]

Others make the point in a different way. Mr. Kramer, of the Foundation Strategy Group, said that "determining the acceptable payout rate is really a function of the asset allocation and period of time the study is conducted. A study could demonstrate that the right payout rate is anywhere from 2 percent to 15 percent depending on the period of time under study and the allocation between stocks and bonds."

A Review of Key Studies

A review of several key studies[46] from the recent past underscores the point that credible conclusions about appropriate payout levels can vary widely.

"Spending Policies and Investment Planning for Foundations" DeMarche Associates, June 1, 1999.[47]

Commissioned by the Council on Foundations and updated in 1999, the study by DeMarche, an investment consulting firm, was released at the height of the Clinton-era stock-market boom. It examined the relationship between foundations' spending policies and the mix of stocks, bonds, and other assets in their investment portfolios.

Citing 49 years of investment data through 1998, with 4 percent average annual inflation during the period, the study concluded that a foundation that spent even a percentage point more than the legal minimum would have seen its portfolio decline in value were it not for the extraordinary market gains of the late 1990s. In fact, it said, a foundation would need a "fairly aggressive" mix of assets to support a distribution rate of even 5.5 percent (including 0.5 percent for investment-management costs and other allowable administrative expenses). If a foundation distributed 6.5 percent of its assets annually, the study concluded, it would need to count periodically on "unusually strong" market returns if it wanted to preserve its portfolio's purchasing power. With a rate of 7.5 percent or more, the purchasing power of a foundation's portfolio would decline.

The study acknowledged that a foundation could have distributed 6.5 percent of its assets during the 49-year period and kept its endowment intact —but only because of the stock market's unusually powerful performance from 1995 through 1998, when the Standard & Poor's 500 index shot up more than 20 percent per year. For 23 straight years, from 1973 to 1996, the assets of a foundation with a 6.5 percent spending rate would have declined after adjusting for inflation, the study concluded.

One other notable point in the DeMarche study: Over a lengthy period, the higher the rate of spending today, the lower the amount of nominal (non-inflation-adjusted) dollars available for spending in the future. A foundation starting with a $1 million portfolio in 1950 would have distributed $9.7 million with a payout rate of 5.5 percent over the 49-year period, compared with $8.4 million at a 6.5 percent payout rate and $7.2 million at a 7.5 percent rate.

Critics have argued that the DeMarche study favors an approach of expanding foundation endowments even beyond today's levels, rather than simply maintaining the endowments' existing purchasing power. They also contend that DeMarche's data actually show that foundations could have paid out up to 6.5 percent over the preceding two decades without eating into their endowments.

"Sustainable Spending Policies for Endowments and Foundations," Goldman Sachs & Co., November 1999[48]

The authors of this study concluded that with a portfolio divided evenly between stocks and fixed-income investments, a foundation with a 5 percent payout would face a greater than 40 percent probability that, over a decade, the real, or inflation-adjusted, value of its corpus, or principal, would decline by more than 10 percent. Even with 70 percent of assets in stocks and the rest in fixed income, a foundation would face at least a 33 percent probability of a 10 percent drop in its principal. At a 6 percent payout, the likelihood of a decline "increases dramatically," but a payout rate of 3 percent to 4 percent "gives reasonable assurance" that the principal would stay intact, the study said.

"If corpus preservation is a priority, foundations should stay as close to 5 percent spending as possible, including management costs," the study concluded. "For endowments, we suggest educating their constituencies regarding the long-term benefits of controlled spending at rates *well below* 5 percent."

When the study was released, James-Keith Brown, director of the institutional nonprofit group at Goldman Sachs Asset Management, said foundations should resist any efforts to compel them to raise their regular payout rate. "We would say that if they had an option — which foundations don't —our preference would be to go down," he said.[49]

"Sustainable Payout for Foundations," Cambridge Associates, April 2000[50]

This study, focusing on a select group of foundations in Michigan, concluded that "payout rates above 5 percent will result in the erosion of a fund's asset value (and therefore its real payout distributions) over time. . . .[T]he current 5 percent payout rate provides founding donors with a reasonable expectation that real payout will be maintained in perpetuity. To raise the currently mandated rate would eliminate that expectation by undermining the ability of private foundations to sustain the purchasing power of their payout over time," Cambridge concluded.

The study was based on three decades of investment data through 1998, projections of future returns for a foundation with 65 percent of its assets invested in U.S. stocks and 35 percent in U.S. bonds, and the tax returns and payout history of 33 Michigan foundations with diversified portfolios from 1973 through 1997. Its conclusions:

- "Simulations using historical index data show that a 5 percent spending rate is perhaps slightly too high to maintain purchasing power in perpetuity. Payout rates in excess of 5 percent almost guarantee the depletion" of the inflation-adjusted value of a foundation's assets over time.

- Data from 33 Michigan funds "do not support a payout rate higher than 5 percent."

- A model of estimated future returns shows that over a 25-year period a foundation with a 5 percent payout rate has a 56-percent probability of maintaining its portfolio's value, but the probability drops to 44 percent if the payout rate is 6 percent. Over a 30-year period, a foundation with a 5 percent payout rate has a 58 percent probability of maintaining the inflation-adjusted value of its assets, but the probability falls to 43 percent with a 6 percent payout.

While the DeMarche, Goldman Sachs, and Cambridge studies all favor keeping payout at no higher than the legal minimum if a foundation wants to stay in business, that research has hardly put the debate to rest. Key ammunition for advocates of higher payout has been another study conducted by a prominent economist at Columbia University.

"Spending Policies for Foundations," National Network of Grantmakers, 1999[51]

Subtitled "The Case for Increased Payout," the study was conducted by Perry Mehrling, chair of Barnard College's economics department at Columbia University, for the National Network of Grantmakers, an association of progressive foundation staff members. In 1999, the network initiated an effort called "1% More for Democracy," aimed at persuading foundations to increase their grant payouts by a percentage point to support social and economic causes.

Mr. Mehrling concluded that a typical foundation could have distributed as much as 8 percent of its assets over a 20-year period through 1994 without a significant decrease in the inflation-adjusted value of its endowment. Moreover, he stated that total charitable payout over that period would have been greater with an 8 percent payout rate than a 5 percent rate.

Critiquing the methodology used in the DeMarche study, Mr. Mehrling suggested that "the goal of a foundation should be to make a 'difference' (or some other analogue to the private firm's 'profit'), not to perpetuate itself as an entity." He also argued that most growth in total grantmaking capacity depends far more on the creation of new foundations and new giving to existing ones than to the reinvestment of returns from existing foundations. "From the point of view of society as a whole, it is not the asset growth of any individual foundation that matters, but rather the asset growth of the entire collection of foundations," he wrote.

Mr. Mehrling concluded that total foundation assets had nearly tripled since 1981 after adjusting for inflation, mainly because of the formation of new foundations and gifts to ones already in place, while grant spending fell from about 8 percent of assets in 1981 to less than 5 percent in 1997. Congress required a minimum payout rate to prevent foundations from turning into "sterile warehouses of wealth," Mr. Mehrling wrote. "Unfortunately, that is exactly what has happened."

Mr. Mehrling's analysis, based on data collected from 44,000 foundations by the Foundation Center,[52] drew fire in part because it included community and operating foundations, which aren't subject to the minimum-payout rule. He defended his method, however, saying separate data for private foundations wasn't available for the period before 1989 and that his study remained valid because private foundations accounted for 85 percent of the assets and three-fourths of the grants made by the funds in his sample.[53]

Mr. Mehrling also drew heat for counting only grants in annual payout, rather than including other expenses, such as rent and compensation. But, he said, "Society does not care how much foundations are spending on their rent, or how much they are giving to their top executives. What is in the social interest is actual charitable giving."[54]

Important Caveats

Critics of studies such as the one by DeMarche contend that by focusing on investment scenarios for individual grantmakers, they miss a bigger point advanced by Mr. Mehrling: Solving tomorrow's demand for charitable resources does not depend solely on what individual grantmakers do today; new money will flow to the philanthropic field in coming decades because 21st century entrepreneurs will create new foundations and an expected intergenerational transfer of wealth will generate new gifts to existing or new foundations.

In addition, some observers question the validity of studies that base their assumptions about foundations' investment performance on information that reaches back decades. "One of the reasons you can't compare 25 years ago to today's investment world is that most foundations were in the hands of amateur investors, and now they're almost all professionals, which minimizes the ebb and flow of the market," said Mr. Eisenberg of Georgetown University.

James Allen Smith, also of Georgetown, makes a similar point: "The framework for investment has changed a lot since 1969," he said. "It would seem to me that we have analytic tools for [investment] return, asset allocation, for thinking about risk, for thinking about social returns that we just didn't have before. There are also financial products such as hedge funds, and some larger institutions are investing more in private placements of equities."

While Mr. Smith said that spending rates of around 5 percent may well be appropriate for many foundations, he noted that wealthier endowed institutions often are able to earn more on their investments than smaller, less-flush ones —something that should be considered when thinking about payout, especially among the largest grantmakers. To underscore the point, Mr. Smith refers to annual endowment surveys conducted by the National Association of College and University Business Officers.

Indeed, those surveys show that over the most recent 10-year period, many higher-education endowments (which are not subject to the federal minimum payout rate) have earned long-term returns, before adjusting for 2.5 percent inflation, far greater than 5 percent. The largest endowments have done the best, on average.[55]

Other Studies

While studies based on investment data have influenced much of the debate on foundation spending, recent research focusing on the social value of payout decisions has helped to move the discussion further into theoretical territory.

Most notable are three controversial studies and articles by people tied to McKinsey & Co., a management-consulting firm that focuses most of its work on the for-profit side of the economy.

One of those studies was published in 2002 by Paul J. Jansen, director of the San Francisco office of McKinsey, and David Katz, a consultant there.[56] The authors applied a standard business concept known as the "time value of money" to the debate over payout from foundations and nonprofit endowments and concluded that "delaying investments in the social sector exacts an enormous cost."

"Today's low distribution rates amount to an implicit decision to hold back funds in the expectation that worthier causes will appear in the future," Mr. Jansen and Mr. Katz wrote. "But many current social needs are already overwhelming. Numerous foundations and endowed nonprofit institutions ought to spend their wealth sooner rather than later, and donors should favor organizations that put their gifts to work straightaway."

Former U.S. Senator Bill Bradley, lead adviser to McKinsey's Institute on the Nonprofit Sector, and Mr. Jansen hit the "now, not later" drumbeat again in 2002 in an article called "Faster Charity."[57] They argued that the business concept of "discounting," in which future investment returns are treated as less valuable than those earned this year, can be applied to foundations. A year later, Mr. Bradley and Mr. Jansen, along with the head of McKinsey's nonprofit practice, stirred the waters again with a highly incendiary study published in the Harvard Business Review.[58] They claimed that nonprofit organizations could free up an estimated $100 billion a year by improving their business and giving practices. Foundations and other endowed organizations alone could distribute an extra $30 billion a year by raising their payout rates to 7 percent from the federally required 5 percent, the authors argued.[59]

For all the attention the McKinsey authors received, some experts dismiss their basic premise that discounting and ideas about the time value of money can be applied to foundation spending. "There are good reasons for foundations to favor high payout rates under certain circumstances, and there may be reasons for the law to mandate minimum payout rates, but the time value of money is not one of them," Michael Klausner, a law professor at Stanford University who specializes in the study of nonprofit organizations, wrote in a pointed rejoinder to the McKinsey studies.[60]

One of Mr. Klausner's basic conclusions about payout is that each foundation —its executives, trustees, and donors—must examine its goals, mission, philosophy, and other intangible principles and come to a disciplined, reasoned decision about how much charity it should hold back from today's generation to provide more giving for future generations. Ultimately, that is an ethical decision, not a mathematical or econometric one, though economics help to highlight the tradeoffs, he argued. The point, Mr. Klausner said, is that grantmakers need to make deliberate decisions about their duty to act in the public interest, however they interpret that duty.

VI: Future Research

For a more strategic approach to payout to take root, huge strides must be made in basic research on foundations and how they make their spending decisions. Such research should build on existing examinations of foundation operations, such as a 2004 Urban Institute study of attitudes and practices related to effective philanthropy. While not focusing on payout, that study, based on a survey of nearly 1,200 independent, corporate, and community foundations, provides strong direction for other research. It found, among other things, that "a substantial number of foundations are not engaging in practices that, by their own standards, are important to effectiveness."[61]

A diverse body of new research on foundation spending would help to inform the debate on payout and provide useful guidance to policymakers and practitioners. While some of this research could be accomplished with econometric measurements, it also demands the kind of qualitative information for which survey research and interviews are best suited. Foundation executives, trustees, donors, staff members, grantees and perhaps even the public —the ultimate consumers of grant dollars —should be included to produce an accurate, well-rounded critique of spending philosophies and their effects.

Among the broad topics and particular questions that researchers should focus on:

Basic data on payout and overhead spending

A top priority should be a comprehensive look at payout and overhead-spending practices at the roughly 65,000 grantmakers in existence, with textured data on a number of questions. For example: How many foundations pay the minimum each year and how many pay more? How many use carry-forward and catch-up provisions to pay out less than 5 percent in a given year?

Payout and administrative expenses

What are the foundations' effective payout rates after subtracting administrative expenses? How do administrative expenses break down among various kinds of foundations and categories of overhead (rent, investment expenses, grantee selection and monitoring, and so on)? Are trustees paid, and if so, how much? To what extent do trustees of one foundation serve on other nonprofit boards, or on for-profit boards?

Direct charitable activity

More research also needs to be done on a part of the foundation world that frequently is lost in the larger spending arena: "direct charitable activity." Paul Brest, president of the Hewlett Foundation, cited as an example of such activity a two-day program Hewlett recently held in its building for people who are interested in disseminating educational material on the Internet. Mr. Brest said that even though Hewlett conducted the program to assist the field of philanthropy, the Form 990-PF treats such activity not as a program but as an administrative expense.

Under current law, such costs can be included in the minimum distribution requirement, but if Congress were to decide to exclude administrative expenses from payout, direct charitable activity might no longer count. Even under today's rules, a foundation that carries out direct charitable activity could seem to have higher administrative costs as a percentage of its total distribution, even though the direct charitable activity may be better characterized as a grant than as an administrative expense. Researchers might study the extent to which foundations spend money on direct-charitable-activity programs, how counting such expenditures as programmatic costs would affect overall grantmaking, and to what degree such programs help grantees.

Capacity-building and operating support grants

Still another area for research is one that might help address the frequent criticism that foundations don't do enough to help grantees with the routine aspects of program administration —everything from buying computer equipment and training staff members to hiring clerical workers and paying the electric bills. To what extent are foundations making these so-called capacity grants? Would changes in federal law that give greater weight to capacity grants in meeting the payout requirement help to improve the efficiency of grantees —and therefore the program results that foundations seek?

Small foundations

A need also exists for research on spending practices at foundations of various sizes, missions, and views on perpetuity. A subset of this research might entail a study of the smallest foundations —those under, say, $10 million in assets. Backers of such funds defend them on the grounds that they help satisfy donors' philanthropic impulses and charities' need for support, have the potential to grow larger with time, and are an important repository of charitable funds as new generations of Americans earn or inherit wealth. But some experts believe small funds should not be tax-exempt. Many such foundations, they argue, lack professional management and sound grant-review standards, are rife with potential to be abusive tax shelters, and are too numerous and difficult for regulators to track. Putting relatively diminutive pools of philanthropic assets into donor-advised funds at community foundations or other public charities is a better option than creating small private foundations, critics argue.

Already, an official in the New York Attorney General's office has said he would like the IRS to stop approving exemption applications for private foundations with less than $20 million in assets.[62] A study of the growth, governance, grantmaking, and payout practices of small funds could help to enhance the understanding of this corner of the foundation field and answer whether these foundations have a value that is commensurate with their tax-exempt status.

Foundation boards and trustees

Better research on foundation boards also is necessary, and one place to start might be with a study on the makeup of boards of trustees. How many trustees, especially among the biggest grantmakers, come from the corporate world or are lawyers? What specific background or experience do foundation trustees have in grantmaking, or in philanthropy in general? Why were they chosen as board members, how long have they served, and what are their views on key questions pertaining to foundation perpetuity, governance, and trustee-compensation standards?

Researchers should also do more to measure the attitudes of trustees —especially those who come from the for-profit world —toward asset building and endowment spending. To what degree are trustees driven by a "bigger is better" philosophy toward asset accumulation? What forces are at work when they decide to spend versus save on grants? How do they weigh and balance the short-, mid-, and long-term needs of the program areas they oversee?

Other kinds of endowments and organizations

How do spending and operating practices of traditional private foundations compare with those of supporting organizations, big university endowments, and other groups that may function similarly to regular grantmakers?

Other questions

Scholars also can do more to test Stefan Toepler's idea of deregulating payout once a foundation's "tax investment" or "debt to the public" is repaid. And what of deregulating payout altogether—an idea that Mr. Deep and Mr. Frumkin treat in their 2001 study?[63]

Stanley Katz, the Princeton professor, sees a need for historical and contemporary research on foundations that choose to spend down their assets in a defined time period—not only early grantmakers such as the Julius Rosenwald Foundation, but those of modern vintage such as the Aaron Diamond Foundation and the Atlantic Philanthropies. "What do the constraints of termination do to foundation strategy?" Mr. Katz said. "Does it impose new pressures? Are there distinctive ways that [so-called limited-life foundations] think about program planning that are different?" Researchers could examine these foundations separately, or they could do side-by-side comparisons of perpetual and spend-down foundations that have similar program areas, such as health or the environment.

Potential Effects of Tax-Law Changes

Researchers also should be watching the Bush Administration's attempt to overhaul the income-tax and Social Security systems and its efforts to eliminate the estate tax. How might such moves affect foundation creation and, ultimately, total foundation spending? If the United States adopted a form of flat tax and did away with deductions for philanthropic giving, should foundation payout be deregulated altogether? What effect would that likely have on grantmaking? And what might be the potential effects on the foundation scene of allowing private Social Security accounts, as the Bush administration has advocated?

Perhaps the most fundamental question for researchers is one that Richard Sansing, the Dartmouth business professor, framed this way: "What value do foundations add that public charities can't mimic?"

"That strikes me as the $64,000 question if we want insights into the foundation sector," Sansing said. "That's got to logically precede any of this fussing about payout rates. I could imagine some quantitative tools brought to bear, but first I want to know what foundations do to add value to the philanthropic sector, to the philanthropic vision."

One way to approach the issue, Mr. Sansing said: by "studying the question of what Foundation X has achieved that couldn't have been achieved more efficiently by just disbursing all its money long ago."

VII: Conclusion

The issues surrounding foundation payout are intricate, and no single economic formula or regulatory policy can adequately address them. Still, a new approach is needed if the debate on payout is to move beyond the traditional question of whether this percentage or that is the "right" number. The broad message of this report is that a change is needed in the institutional thinking of foundations, starting with a willingness to engage in a candid discussion about payout. Ultimately, foundations should move toward a system in which spending decisions are more strategically tied to individual grantmaking missions.

At the same time, three related issues demand more attention from foundations, policymakers, the media, and researchers. One is the foundation excise tax, whose two-tier approach is justly criticized. Changing the excise tax is a rare point of consensus in the debate over payout and should be taken up promptly by Congress.

More difficult to resolve is the issue of whether administrative expenses should be included in payout calculations. Credible arguments are made on both sides of this debate. Finding a middle ground between unlimited inclusion of overhead in payout and an outright ban appears to be the best approach. A place to start is to identify foundations that spend at the upper, lower, and middle ranges on salaries, trustee fees, rent, and other kinds of overhead. Having better benchmarks would help to sharpen the discussion on administrative expenses while, at the same time, identify foundations that spend excessively on overhead.

A third area that requires attention is that of oversight, by government officials and by the foundation sector itself through a system of self-regulation. Fixing the excise tax and using its proceeds for their original intent —oversight of the nonprofit world —is a good place to start. Also key is a stronger system of self-monitoring among foundations. Even with effective self-regulation, however, federal and state officials, and most of all Congress, should recognize the need for substantially more resources to adequately monitor foundations and the entire nonprofit world.

Toward a Strategic Approach

The constellation of excise taxes, overhead, and oversight must be viewed against the larger backdrop of the payout requirement. A shift in focus on payout toward a strategic, mission-based approach would accomplish a number of objectives:

- Grant money would be deployed with maximum effectiveness. By thinking more strategically about mission, and reviewing mission goals frequently, foundation officials would ensure that their focus remains on the intent and results of programs, not on meeting arbitrary payout guidelines or preserving assets for preservation's sake. Such a shift would, over time, also help foundation officials open a dialogue with living donors and prospective contributors about the pros and cons of seeking foundation perpetuity.

- By systemically reviewing payout practices in light of program missions, foundations would be more sensitive to the needs of grantees and the financial challenges they face. A payout approach built on mission would encourage foundations to aid grantees with all aspects of program work that contribute to mission success —including supporting legitimate needs for operating help. In addition, a stronger link between mission and payout would encourage foundations to take the long view in allocating resources, rather than automatically reverting to a prescribed target distribution rate of, say, 5 percent of assets. Such a long view would reduce the likelihood that foundations would leave grantees in the lurch by withholding money during declining economic cycles, when support is needed most.

- By better tying payout to mission, foundations could defuse some of the regulatory pressure and public scrutiny that have arisen in recent months. If payout decisions, including spending on overhead and administration, are guided by carefully documented mission goals, and if those decisions and goals are explained fully in ways stakeholders and policymakers can understand, foundations will reduce the mystery and suspicion surrounding their operations.

While payout levels vary among foundations of different types and sizes, the required minimum has become a de facto ceiling for many grantmakers, especially larger and more established ones. Various factors account for this. Legal stipulations in wills and trust agreements, for example, may require a grantmaker to operate in perpetuity, leading trustees to exercise extreme caution in spending assets. More broadly, the requirements of fiduciary duty naturally make the guardians of foundation assets fiscally conservative.

Yet the relative lack of pluralism in foundation payout rates suggests that many grantmakers have accepted the 5-percent target without doing enough to weigh their spending practices against the missions they seek to accomplish or the role foundations play in a democratic society. The dimensions of the problem are difficult to measure because of the dearth of useful research on payout practices and the need for greater transparency in foundation operations. Too often foundations guard their payout policies and grantmaking deliberations zealously and resist opening their governance decisions to scholarly study or public examination.

This insularity affects many other areas of foundation operations besides payout. In the Urban Institute's 2004 study of nearly 1,200 independent, community, and corporate grantmakers, researcher Francie Ostrower found that among foundations that said it was very important to solicit outside advice to be effective, 26 percent said community input was not at all or not very important in the formulation of their grantmaking program priorities. Nearly a third had not brought people together from outside the foundation to inform foundation activities. And more than 60 percent had not solicited grantee feedback through surveys, focus groups, or interviews.[64] Such findings help to reinforce the image, fairly or unfairly, of foundations as elitist organizations whose management practices and spending policies are opaque by design.

To accomplish a change in institutional behavior, foundation trustees must undertake a challenging balancing act: fulfilling their fiduciary obligations of duty, care, and loyalty in safeguarding assets, yet whenever possible shifting their focus from one primarily concerned with corpus preservation to a broader one of matching spending decisions with mission and needs. Ultimately, that is an ethical obligation that rivals in consequence the more familiar legal requirements of fiduciary duty.

Appendix: Selected Examples of Approaches to Payout

The three foundations briefly profiled below show various facets of the payout debate. Their selection is not meant to suggest a complete picture of the types, sizes, or missions of foundations subject to the payout rule. The Munson Foundation is a small organization with family influences that has taken deliberate steps to examine issues of perpetuity, the link between payout and mission, and the need for flexibility with grantees. The Skoll Foundation is one of a new breed of fast-growing, cutting-edge foundations fueled by an infusion of assets from wealthy entrepreneurs —typically people involved in the technology industry. The Nathan Cummings Foundation is a relatively large organization that has taken affirmative steps to help grantees weather economic cycles.

The Curtis and Edith Munson Foundation

In June 2001, on its 15th anniversary, the Curtis and Edith Munson Foundation did some soul-searching.

For most of its life as a grantmaker focusing on conservation and natural-resource issues, Munson had distributed 5 to 6 percent of its assets annually, including administrative expenses —a payout rate typical of American foundations.

By 2000, the stock market was setting records, the foundation's assets were peaking at $41 million, and Munson was paying out closer to 5 or 6 percent *without* counting administrative costs —not a big deal, perhaps, in light of the heady days on Wall Street.

It's what Munson's board did in mid-2001, as the economy began to sour and the stock market began to fall, that is noteworthy, said Angel Braestrup, Munson's executive director. After careful deliberation, trustees affirmed their commitment to spend at least 5 percent per year on grants alone. Administrative costs would no longer be counted toward payout.

Moreover, said Ms. Braestrup, the board left open the possibility of spending more if the right situations should arise. "If there were a major project or program or opportunity that needed a large chunk of change, it would be added on —not taken out of the existing grants program," she said. "In other words, we wouldn't change our existing commitment to our grantees. Our assets are not inviolate, nor is the threshold [for grants] absolute. That was important to the board."

Those decisions came despite a drop of 11 to 15 percent in the value of Munson's portfolio in the difficult investment year of 2001. The foundation now has about $32 million in assets, and Ms. Braestrup said it has given away about $8 million since 1999. "If the endowment goes down, we don't adjust downward. We try to ensure that we complete all our internal commitments" to grantees.

As significant as the technical facts of Munson's spending is the process that the board undertook in arriving at them. When they sat down to discuss payout, the trustees —all great-nephews of the foundation's founders, both of whom are deceased —faced a number of questions common to many foundations. Should the Munson Foundation seek to exist in perpetuity? How might the expected intergenerational transfer of wealth affect the amount of money available for conservation causes, and should the foundation take that into account in setting its own payout standards? Should the next generation of Munson family members, some of whom won't reach adulthood before the current trustees retire, have the opportunity years hence to put their own stamp on grantmaking?

For some trustees, Ms. Braestrup said, perpetuity "wasn't front and center," but others wanted to leave the door open for the next generation of family members to be involved. After examining various spending options and carefully reviewing the foundation's payout history, the board settled on the decision that would allow it to sustain its grantees while ensuring that Munson has enough assets to continue into the foreseeable future. "Our fundamental argument was threefold," Ms. Braestrup said. "The problems [of conservation] are here and now, we have the money here and now, and each generation has successfully made enough money to create a form of philanthropy so there will be money coming behind us" from the bigger universe of conservation donors.

Ms. Braestrup said every foundation, whatever its ultimate decision on payout, should go through the introspective exercise that Munson's trustees undertook.

"The question they should really be asking is whether the level of payout they're making now in grants alone is getting as much done as they would like. Are there things they could do today, opportunities they could take advantage of, that would eliminate the need of them spending this money in 10 years?"

Foundations also should consider a point that has been important to the Munson board, she said: "Are we being flexible in our payout philosophy so that when we have a new idea and develop new goals and focuses, we don't undo what we've already done by making the transition too abrupt?"

All those are important issues, Ms. Braestrup said, "It's too easy to forget that a private foundation is still a public trust, and money is there to be given away."

The Skoll Foundation

When Jeffrey Skoll, the first employee and first president of the Internet auction site eBay, created the Skoll Foundation in October 2002, he adopted both the language and the spending philosophy of what is known as "strategic" philanthropy.

Grants aren't so much distributions of money to charities as they are "investments" in "social entrepreneurs." Groups receiving Skoll money don't just use it for good works — they "leverage" the funds with the aim of getting a "social return on investment." Programs supported by Skoll seek to tackle a variety of problems —poverty, poor housing, environmental degradation, for instance —simultaneously, depending on the creativity of the social entrepreneur.

The approach of the Skoll philanthropy comes from the business world, and its payout strategy is evolving to reflect the premium that business executives put on adaptability and emerging opportunities.

"We feel we have the kind of flexibility to be very responsive and opportunistic to some degree, because the foundation has been growing so rapidly," said Sally Osberg, the foundation's CEO. "We don't have to stay yoked to a budgeted payout number."

The Skoll Foundation is emblematic of a number of wealthy foundations, many of them financed by money from the technology industry, that are new to the philanthropy scene. Their ascendancy helps give currency to the view that old-line grantmakers should be paying out more of their assets each year because new money is coming along behind them to help tackle tomorrow's challenges.

With money that comes from the sale of his eBay stock, Mr. Skoll continues to expand the foundation as well as a separate supporting organization of the Community Foundation Silicon Valley called the Skoll Fund, formed in 1999. Currently the foundation's assets total about $200 million, and the Skoll Fund is of similar size, Ms. Osberg said.

Because the foundation is new and has an active donor, she says, "calculating payout is fluid. We try to true it up twice a year . . . based on the [asset] base, but also on a scan of needs and opportunities." For the 12 months ending June 30, 2004, the foundation and supporting organization had assets totaling about $382 million, and grant awards totaled about $25 million, according to information provided by comptroller Richard Fahey.

A basic philosophy of the Skoll philanthropies, Ms. Osberg said, is "that there is a responsibility to be more generous when times are tough and to ratchet back as much as possible when times are good" to preserve assets for future needs.

As an example of the former, Ms. Osberg noted that the Skoll Fund spent $2.5 million two years ago to create the Urgency Fund, a special effort to support struggling charities in Silicon Valley. Many charities there and around the nation faced declining donations in the aftermath of the 2001 terrorist attacks and the recent economic slowdown and, at the same time, rising demand for charitable services. Last year the Skoll Fund gave $5 million to the community foundation to mark its 50th anniversary. The gift was intended to help stimulate unrestricted donations to the community foundation, Ms. Osberg said.

Mr. Skoll intends to keep the Skoll Foundation alive in perpetuity, and payout policies will be shaped with that goal in mind, she said.

"You have to stay open to the innovations, the big new ideas and opportunities that will arise and could conceivably have far greater leverage than anything right in front of you now," Ms. Osberg said. "That's why he's built the case for the foundation being organized in perpetuity rather than as a spend-down proposition."

Still, because Mr. Skoll is young —he turned 40 in January 2005 —spending decisions will remain a work in progress, Ms. Osberg suggested.

If the right opportunity came along to create what she called an "order-of-magnitude positive change" in a difficult problem facing the world, "that would be the case for spending more rather than managing spending."

"But absent that very-high-leverage opportunity … it could be construed as spending for spending's sake. You really do have to have a strategy. You have to see the leverage. You have to make the smart subsidy."

One way to do that, she said, is to budget not just for grantmaking, but also for investments that align with the foundation's social purpose—something not new to such old-line philanthropies as the Ford and MacArthur foundations but gaining recognition among a number of recently created grantmakers. Skoll, for example, has put money into a bond that will provide loan capital to microfinance institutions worldwide. Such institutions help people in emerging economies start and sustain businesses that can help ameliorate a number of different problems, such as poverty, homelessness, exploitation of natural resources, and so on.

"Ultimately," Ms. Osberg said, "we want to see more of the foundation's assets being deployed for social and environmental returns as well as financial returns."

The Nathan Cummings Foundation

"Continuity," "programmatic stability," and "smoothing" are words that that have become mantras for the Nathan Cummings Foundation.

Amid the ups and downs of the investment market since the mid 1990s, the foundation has sought ways to accomplish a dual objective: to preserve the buying power of its endowment, currently about $428 million**,** and also avoid leaving its programs and grantees in the lurch by abruptly changing its distribution levels from year to year.

Over the past decade, the foundation's trustees and specifically its finance committee have spent hours shaping a payout strategy that would accomplish both aims. In the early 1990s, as the estate of businessman Nathan Cummings was being settled, the board set a payout level of 5 percent of the endowment's monthly average for the preceding year. The board also stipulated that payout could go no higher than 6 percent or lower than 4 percent of the current years' endowment value, even if investment performance changed abruptly.

Then, in 1996, the foundation decided to peg its spending to 5 percent of a three-year rolling average of its endowment's market value, again with the 6 percent and 4 percent limits. Most recently it pegged that formula to a five-year rolling average, better to smooth out fluctuations in the money it has available for grants, said Caroline Williams, the foundation's chief financial and investment officer.

In 2000, at the height of the stock-market boom, the Nathan Cummings board started a short-lived program aimed at sharing investment windfalls with grantees. By 2001 the market had crashed, and the program was canceled with less than half the extra money spent. The rest went back into the endowment, to be saved for rainier days when grantees and programs would need the money more.

"The board said we'd prefer a philosophy where you don't ramp up spending when there's a windfall but instead save it and be countercyclical when there are contractions in the market," Ms. Williams said.

The Nathan Cummings Foundation never saw its endowment melt down the way some foundations did. In its worst year for investing, it posted a 2.5 percent negative return, Ms. Williams said. Still, the foundation's endowment rose and fell in broader swings once grants and administrative costs were factored in. The endowment declined from $414 million at the end of 1999 to $350 million at the end of 2002, then began to recover, she said.

In 2004, the foundation decided to set its payout at 5 percent of the trailing five-year endowment average, not counting administrative expenses. While that was a formal decision for 2004, Ms. Williams said that since the mid-1990s Nathan Cummings payout had been at about that same level —a grants-alone distribution of 5 percent.

For 2005, the foundation will take a different approach to payout, Ms. Williams said. From an investment perspective, the foundation is "doing quite well," but it wants to protect grantees and programs from bumps down the road, so the foundation is "not sharing all the upside this year," she said.

"It's important to be countercyclical, so we're actually trimming the grants budget a bit," she said. "It's going to be more like 4.5 percent" of the trailing five-year average.
"It's been a good [investment] market this year, but we have concerns about the market going forward. There's a fair amount of risk in the market. So we thought it would be prudent to be a bit countercyclical here and not share all the wealth but hold some of it for what we expect to be a downturn over the next few years."

She comes back to the Nathan Cummings mantra. "The worst thing that can happen is to have to reduce or eliminate a foundation program, such as those focusing on global warming or energy efficiency, because of a downturn in the investment markets," she said. "Continuity for our program efforts" —that, Ms. Williams said, is what is paramount.

About the Author

Thomas J. Billitteri is an independent writer and researcher, specializing in nonprofit issues. He is a former news editor and staff reporter of *The Chronicle of Philanthropy* and has held reporting and editing positions at the *St. Petersburg Times*, *Dallas Times Herald*, *Religion News Service*, and *Florida Trend* business magazine, among other media outlets. Billitteri is the author of two recent books for the young-adult market, on juvenile rights and alternative medicine, and has written on teacher education and other policy issues for the *Congressional Quarterly Researcher*. He has taught journalism classes at the University of Maryland, Michigan State University, and other institutions, and spoken widely on nonprofit and business topics. Billitteri holds a bachelor's degree in English and a master's degree in journalism, both from Indiana University in Bloomington. He lives in Fairfield, Pa.

Notes

---

[1] Private non-operating foundations are required by federal law to distribute at least 5 percent of the previous year's average monthly value of their net investment assets. The payout can include both grants and administrative expenditures related to a foundation's charitable purpose, including program research and evaluation, trustee compensation, and publishing. Calculating payout is a complex process that includes a concept called "carryover," which allows foundations that exceed the minimum distribution requirement in a given tax year to carry over the excess to help cover its spending obligations for up to the following five years. Thus, payout in a given year could appear lower than the required minimum.

[2] About 17 percent of 67,543 foundations that reported on Form 990-PF to the IRS in 2002 could be classified as pass-through organizations, meaning that they made grants of 25 percent or more of the fair market value of their assets, according to the Urban Institute's National Center for Charitable Statistics. The proportion of groups ranged from 18 percent of those that made grants of between $1 and $100,000, to 28 percent of those making grants of $1 million or more. By assets, the range was 34 percent of those with assets of $1 to $100,000, and 3 percent of those with assets of $10 million or more.

[3] See, for example, Evelyn Brody, "Charitable Endowments and the Democratization of Dynasty," *Arizona Law Review*, University of Arizona College of Law, Vol. 39, No. 3, Fall 1997.

[4] 1965 Treasury Department Report on Private Foundations, cited in Commissioner v. "Americans United" Inc., 416 U.S. 752 (1974), footnote 8 of Blackmun dissent.

[5] C. Eugene Steuerle, "Foundation Giving: Will it Follow the Bubble Economy," June 21, 1999. http://www.urban.org/url.cfm?ID=1000165. "Economic Perspective" column reprinted with permission, copyright 1999, *Tax Analysts*.

[6] Senate Finance Committee, 108th Congress, "Staff Discussion Draft," June 2004 http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.

[7] Melissa Whitten, "Large Nonoperating Private Foundations Panel Study, 1985-1997," *Statistics of Income Bulletin*, Summer 2001.

[8] Richard Sansing and Robert Yetman, "Governing Private Foundations Using the Tax Law," *Journal of Accounting and Economics* (Forthcoming).

[9] Akash Deep and Peter Frumkin ,"The Foundation Payout Puzzle," The Hauser Center for Nonprofit Organizations, Kennedy School of Government, Harvard University, working Paper No. 9, June 2001. The authors state, for example, that some proponents of higher payout contend that spending more now will curb social problems before they get worse, that delaying payout is unfair to the current generation that subsidizes tax deductions for today's donors, and that new money will enter philanthropy to replace amounts spent today. Conversely, the researchers noted, some contend that foundations should save their money for the future, when certain social problems may be even worse than today or new ones may emerge, and that investment markets are so uncertain that spending more today might erode a foundation's endowment and prevent it from doing good tomorrow. Mr. Deep and Mr. Frumkin also state that the "weight of tradition and professional experience" is a factor in maintaining the status quo on payout. For more background on payout and endowments, see also Brody, op. cit., and Henry Hansmann "Why Do Universities Have Endowments?," *Journal of Legal Studies*, University of Chicago Press, Vol. 19, January 1990.

[10] Association of Small Foundations, "2004-2005 Foundation Operations and Management Survey," October 2004.

[11]"Foundation Growth and Giving Estimates, 2003 Preview:" Foundation Center, 2004: See, "Outlook for Foundation Perpetuity," page 10. See also, "After Holding the Line for Two Years, Foundation Giving Declined in 2003," Foundation Center press release, April 5, 2004, http://fdncenter.org.

[12] See The Duke of Norfolk's Case, 1682. See also the Statute of Mortmain, 1279.

[13] For historical background on endowments and England's treatment of land, see Brody, op. cit., starting at 899.

[14] Thomas Jefferson, letter to James Madison, September 6, 1789.

[15] Julius Rosenwald, "The Burden of Wealth," *The Saturday Evening Post*, 1929. Quoted in Diane Granat, "America's 'Give While You Live' Philanthropist," *APF Reporter* Vol. 21, #1.

[16] For an explanation of the origins of the 1969 law on private foundations see, Thomas A. Troyer, "The 1969 Private Foundation Law: Historical Perspectives on its Origins and Underpinnings," Exempt Organization Tax Review, January 2000.

[17] See, for example, Waldemar A. Nielsen, *The Golden Donors*, Truman Talley Books, E.P. Dutton, 1985, at 26; and James Allen Smith, "Foundations and Public Policymaking: A Historical Perspective," Research Report-11, The Center on Philanthropy and Public Policy, University of Southern California, 2002.
[18] Ibid, 7-8.
[19] Despite the lack of any change in economic data during the period, the House Ways and Means Committee, still upset at foundations and suspicious that some were being used as abusive tax shelters, raised the target distribution rate from around 3.5 percent of investment assets to 5 percent, according to Mr. Troyer. The Senate subsequently raised it to 6.
[20] Part of the problem with this adjustment approach was that it made the annual payout rate "procyclical" with the economy—that is, when money rates and investment yields rose, so too would payout, and vice versa, making it likely that grantees would get more foundation money when they might need it less, and less money when they might need it more. See the discussion in this section. It is also worth noting another problem inherent in having Treasury adjust the payout rate annually, an idea that still has favor in some circles today: Foundations didn't like the approach partly because it made it difficult for them to set annual budgets or offer financial stability to grantees.
[21] Steuerle, "Distribution Requirements for Foundations," U.S. Treasury Department, OTA Paper 12, May 1976.
[22] Ibid. See also Steuerle, "Foundation Giving: Will it Follow the Bubble Economy?" op. cit.
[23] An important issue concerning payout has to do with the Uniform Management of Institutional Funds Act (UMIFA) of 1972, which provides guidance to charity boards on the investment and expenditure of endowment funds. UMIFA, which has been adopted by most states, allows endowment managers to spend any amount of an endowment gift above its historic dollar value—the value of the gift when it was originally donated—if they do so prudently and the donor has not required other spending restrictions. That has meant that endowment managers could spend the interest, dividends, and investment gains earned on gifts but not deplete the principal. When the stock market declined after the bubble of the late 1990s, some endowment funds fell below their historic dollar value, making it hard for endowment managers to meet the 5 percent payout standard without violating UMIFA's historic-dollar-value rule. Currently a committee of the National Conference of Commissioners on Uniform State Laws is drafting revisions to UMIFA that would abandon the use of historic dollar value as a baseline for endowment expenditures and give more latitude to institutions in endowment spending.
[24] Stefan Toepler, "Ending Payout as We Know It: A Conceptual and Comparative Perspective on the Payout Requirement for Foundations," *Nonprofit and Voluntary Sector Quarterly*, vol. 33, no. 4, December 2004. Mr. Toepler is also a nonresident scientific partner of the Maecenata Institute for Philanthropy and Civil Society at the Humboldt University of Berlin.
[25] For useful background on administrative expenses, see, "Private Foundation Grantmaking Administrative Expenses Study," Internal Revenue Service, January 1990. The study found, among other things, that during the 1985 tax year, 7.1 percent, or $417 million, of the $5.9 billion in qualifying distributions among non-operating private foundations was attributable to grantmaking administrative expenses. The 1986 tax code's limit on administrative expenses "was not an effective method of discouraging foundations from incurring excessive amounts" of such expenses, the study also found. Small foundations were the most likely to incur excessive expenses but also tended to have excess qualifying distributions, the study found. In no instance was a tax incurred as a result of a foundation exceeding the expense limit, according to the study. Moreover, the study found that "private foundations were in substantial compliance with the provisions of the tax laws that apply to them."
[26] "Foundation Growth and Giving Estimates, 2004 Preview," Foundation Center, 2005. See, "Majority of Funders Provided General Operating Support," page 9.
[27] See "Helping Charities, Sustaining Foundations: Reasonable Tax Reform Would Aid America's Charities, Preserve Foundation Perpetuity and Enhance Foundation Effectiveness and Efficiency," NCRP analysis of Section 105 of H.R. 7, the Charitable Giving Act of 2003, June 2, 2003.
[28] "Foundation Center Statement on Source Data Used in NCRP Report and Implications for Findings," June 16, 2003.
[29] "A Billion Here, A Billion There: The Empirical Data Add Up: NCRP's Second Report on How Sec. 105 of H.R. 7 Would Help Charities, Preserve Foundations and Encourage Their Efficiency," July 8, 2003.
[30] Harvy Lipman and Ian Wilhelm, "Pressing Foundations to Give More," *The Chronicle of Philanthropy*, May 29, 2003.

[31] Elizabeth Schwinn, Ian Wilhelm, Grant Williams, "Former Congressman to Fight Foundation Bill," The Chronicle of Philanthropy, June 12, 2003; and Brad Wolverton, "Two Groups Oppose Foundation Measure," *The Chronicle of Philanthropy*, June 26, 2003.
[32] "A Cost of Giving Adjustment? Should Administrative Expenses Be Excluded from a Foundation's Qualifying Distributions?," taped transcript edited by participants in a breakfast discussion presented by the Hudson Institute's Bradley Center for Philanthropy and Civic Renewal, Washington, DC, June 17, 2003.
[33] Ibid.
[34] Senate Finance Committee, 108th Congress, "Staff Discussion Draft," June 2004. http://finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.
[35] Christine Ahn, Pablo Eisenberg, and Channapha Khamyongsa, "Foundation Trustee Fees: Use and Abuse," Center for Public and Nonprofit Leadership, Georgetown Public Policy Institute, September 2003.
[36] Philanthropy Expansion and Responsibility Act of 2003, S. 1514, July 31, 2003.
[37] "Building Strong and Ethical Foundations: Self-Regulation and Government Enforcement," Dorothy S. Ridings speech to the National Association of State Charity Officials Conference, October 25, 2004.
[38] "Council on Foundations Launches Accountability Initiative," press release, June 6, 2004. For an example of a state effort, see Delaware Valley Grantmakers, "Statement of Values, Guiding Principles and Best Practices for DVG Members," http://www.dvg.org/news_media/Guiding%20Principles%20FINAL%20w%20Logo.pdf.
[39] For a history and analysis of the foundation excise tax, see Catherine E. Livingston, "Analysis of the Repeal of the Section 4940 Excise Tax," prepared for the Council on Foundations and available on the Web site of the Association of Baltimore Area Grantmakers at http://www.abagmd.org/info-url3989/info-url_show.htm?doc_id=204851; See also, Marion R. Fremont-Smith, *Governing Nonprofit Organizations: Federal and State Law and Regulation*, Belknap Press of the Harvard University Press, 2004.
[40] "Written Statement of Mark W. Everson, Commissioner of Internal Revenue, Before the Committee on Finance, United States Senate, Hearing on Charitable Giving Problems and Best Practices," June 22, 2004.
[41] "Excise Tax on Private Foundations," issue paper, The Council on Foundations, January 2004.
[42] Elizabeth T. Boris and C. Eugene Steuerle "Payout and Related Public Policy Issues," the Urban Institute Center on Nonprofits and Philanthropy and the Harvard University Hauser Center for Nonprofit Organizations, June 2, 2004. See also Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," *American Journal of Tax Policy* 12, No. 2, fall 1995, or The Exempt Organization Tax Review 13, no. 5, May 1996.
[43] Adam Meyerson, "Response to Senate Finance Committee Discussion Draft," July 22, 2004.
[44] Livingston, op. cit.
[45] Council on Foundations Board Briefing #1: Payout, Fall 2000.
[46] See also John E. Craig Jr., "In Favor of Five Percent," Foundation News & Commentary, May/June 1999.
[47] "Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation's Asset Mix," Third Edition, Carter R. Harrison, DeMarche Associates, Overland Park, Kansas. The study was an update to ones produced in 1990 and 1995.
[48] "Sustainable Spending Policies for Endowments and Foundations," Stanley Kogelman and Thomas A. Dobler, Goldman Sachs & Co., New York, November 1999.
[49] Marina Dundjerski, "To Live Forever, Foundations Should Give Away the Minimum, Reports Say," *The Chronicle of Philanthropy*, November 18, 1999.
[50] "Sustainable Payout for Foundations," Cambridge Associates Inc., commissioned by the Council of Michigan Foundations, April 2000. The study was supported by grants from the Charles Stewart Mott Foundation, Kresge Foundation, W.K. Kellogg Foundation, Herbert H. & Grace A. Dow Foundation, and Mawby Fund of the Council of Michigan Foundations.
[51] "Spending Policies for Foundations: The Case for Increased Grants Payout," Perry Mehrling, 1999, for the National Network of Grantmakers, San Diego.
[52] Dundjerski, op. cit.
[53] Ibid.
[54] Ibid.
[55] See "2004 NACUBO Endowment Study," National Association of College & University Business Officers. College and university endowments of greater than $1 billion had a 10-year nominal return of 12.5 percent, while those with $500 million or less had returns below 9 percent. The Consumer Price Index for all urban consumers (CPI-U) ran a seasonally adjusted 2.5 percent during the 10-year period.
[56] Paul J. Jansen and David M. Katz, "For Nonprofits, Time Is Money," *The McKinsey Quarterly*, 2002, No. 1.

[57] Bill Bradley and Paul J. Jansen, "Faster Charity," *The McKinsey Quarterly*, Web exclusive, June 2002. See also, "Faster Charity," Bradley and Jansen, *The New York Times*, May 15, 2002.
[58] Bill Bradley, Paul Jansen, and Les Silverman, "The Nonprofit Sector's $100 Billion Opportunity," *Harvard Business Review*, May 2003.
[59] See Stephanie Strom, "Billions in Charity Money Could be Saved, Study Says," *The New York Times*, May 10, 2003
[60] Michael Klausner, "When Time Isn't Money: Foundation Payouts and the Time Value of Money," *Stanford Social Innovation Review*, Vol. 1, No. 1, 2003; also in *Exempt Organization Tax Review*, Vol. 41, issue 3, September 2003.
[61] Francie Ostrower, "Attitudes and Practices Concerning Effective Philanthropy," The Urban Institute Center on Nonprofits and Philanthropy, April 2004. The study is available online at http://www.urban.org/url.cfm?ID=310986.
[62] Grant Williams, "Making Philanthropy Accountable: New York's Top Regulator Pushes for Far-Reaching Changes," *The Chronicle of Philanthropy*, June 26, 2003.
[63] Deep and Frumkin, supra.
[64] Ostrower, op cit.