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Volume Author/Editor: Charles T. Clotfelter

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Chapter Author: Charles T. Clotfelter

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7 Foundations

It is impossible to make a full assessment of the effects of federal taxation on charitable giving without considering the unique role played by philanthropic foundations. Sometimes compared to banks or clearing houses,[1] foundations act primarily as intermediaries between contributors and the nonprofit organizations that provide charitable or other exempt services. As such, foundations do not originate charitable transfers; they merely complete them. In 1982 American foundations made grants amounting to $3.2 billion, or about one-fifteenth the size of donations by living individuals (*Giving U.S.A.* 1983, p. 36). Since these grants were made possible only by earlier contributions or bequests, it is improper to add foundation grants together with current contributions from all other sources. To do so would result in a double counting of gifts passing through foundations. Despite this intermediary role, foundations and their tax treatment loom large in the consideration of tax policy and the philanthropic sector. Tax provisions regarding foundations affect not only their institutional behavior but the nature and amount of gifts they receive.

The first section of this chapter provides a brief outline of the history, structure, and function of charitable foundations in the United States. The second section describes recent tax provisions affecting foundations, focusing particularly on the Tax Reform Act of 1969. The third section discusses the effects of tax laws—with emphasis on the 1969 act—on the behavior of foundations and potential donors. No econometric analysis is discussed because virtually none exists in this area comparable to the studies of tax effects in other areas of charitable behavior.

1. See, for example, Nielson 1979, p. vii, and Ture and Feulner in Butler 1980, p. ix.

7.1 Background

The modern charitable foundation traces its legal roots back into antiquity, but it was not until the twentieth century that its present form became solidified. Through a foundation, one or more individuals can establish a permanent mechanism to manage a sum of money and make charitable grants from it. The purposes to which the grants are to be applied may be stated in quite general terms. The tasks of managing the principal and distributing grants are left to directors or trustees who may well be related to the donor, but most of the largest foundations have come to be directed and operated by professionals and others largely unrelated to the donors.[2]

It is useful to distinguish several types of foundations, both for descriptive purposes and for the sake of understanding relevant tax legislation. The most visible are the large private institutions such as the Ford and Rockefeller foundations. There are many more smaller foundations of similar structure, most of which were established by the gifts of a single family or individual. Together these foundations are referred to as private nonoperating foundations. They are "nonoperating" because, for the most part, they make grants to other organizations rather than supplying services directly. In addition, their endowments come largely from one or several gifts from an individual or family rather than from the continuing support of a large number of contributors. It is the tax treatment of these private nonoperating foundations that has inspired the most intense policy debate in this area of nonprofit activity, and these foundations are the focus of the present chapter.

In order to point up the distinguishing features of private nonoperating foundations, it is useful to mention four other general categories of foundations. First, company foundations are those closely allied to firms, and their function is discussed in chapter 5. Second, community foundations (known also as community trusts) serve to centralize the administration for separate charitable funds in a community or region. Third, "operating foundations" such as endowed research or social-welfare organizations provide tax-exempt services directly. Although they are strictly a kind of private foundation, they act as ordinary charitable organizations rather than as grant-making entities. Finally, it is useful to distinguish a group of organizations that operate by attracting contributions from a wide spectrum of contributors and funneling that money to research or service organizations. Exemplified by organizations supporting health-related research, such "public charities" do not provide services directly, but are distinguished from private foundations by the breadth of their support.[3]

2. For historical descriptions of foundations, see Freemont-Smith 1965 or Karl and Katz 1981.

3. See Petska (1982a, p. 9) for examples of public charities or Freemont-Smith (1965, p. 12) for a similar categorization of foundations.

For the sake of clarity in evaluating data on foundations, it is important to note that the legal definition of *private foundation*—on which government statistics and tax treatment are based—covers more than just private nonoperating foundations. In particular, the definition of a private foundation as used by the IRS includes operating charities that fail to meet certain standards of public support (so-called failed public charities) or other conditions. Not only does this definition have important implications for the tax treatment of insitutions, it also means that government data on private foundations includes some number of organizations that do not conform to the usual definition of grant-making, nonoperating foundations. In fact, most private foundations are grant-making and nonoperating, thus conforming to the definition of private nonoperating foundations. Community foundations and most operating charities are not included in the IRS definition of private foundations. The distinction between private nonoperating foundations and the legal definition of private foundations is noted below in discussing the size and composition of the foundation sector.

Table 7.1 provides some idea of the magnitudes of the various foundation types, based on a sample of large foundations for 1979. Private nonoperating foundations constitute by far the most important category, accounting for 78 percent of these large foundations and 88 percent of their assets.[4] Company foundations accounted for 5 percent of assets, while community and operating foundations together made up the remaining 7 percent. As a percentage of assets, current contributions received by foundations were most important to company foundations, which is quite consistent with the idea that such foundations smooth out contributions rather than serve as repositories of endowments.[5] In contrast, current contributions received by private nonoperating foundations accounted for only 1.4 percent of assets, reflecting the general dominance of initial gifts relative to continuing outside support. Grants made by private nonoperating foundations amounted to 5.6 percent of assets, or four times as large as contributions received. In contrast, company foundations paid out slightly less than their receipts of contributions, though both amounts were large relative to total assets. The grants of community foundations were less than a third of their contributions received, and grants by operating foundations were of little importance.

7.1.1 Size and Function of Private Foundations

Because of the central role of private foundations in discussion of tax policy and recent tax legislation, it is useful to take a closer look at this segment of the foundation world. Based on mandatory tax and informa-

4. The Foundation Center uses the term *independent foundation* for private foundations (*Foundation Directory* 1981, p. ix).

5. For a further discussion of this point, see chapter 5.

Table 7.1 **Assets, Contributions Received, and Grants Made for Large Foundations by Type, 1979 (dollar amounts in millions)**

	Private Nonoperating[a]	Company Sponsored	Community	Operating	All
Number[b]	2,618	602	95	48	3,363
Assets	$33,829	$2,008	$1,655	$1,061	$38,553
Contributions received	$ 478	$ 509	$ 345	$ 24	$ 1,356
As percentage of assets	1.4	25.3	20.8	2.3	3.5
Grants made	$ 1,910	$ 438	$ 102	$ 33	$ 2,483
As percentage of assets	5.6	21.8	6.2	3.1	6.4

Source: Foundation Directory 1981, p. vii.

[a]Identified as "independent" foundation by the Foundation Center.

[b]All foundations meeting specific size criteria were included in this tabulation.

tion returns, the IRS estimated that there were almost 28,000 private foundations in 1979. As large a number as this appears to be, returns for private foundations represented in 1975 only a quarter of the returns filed by all exempt organizations and only 7 precent of all expenditures for exempt purposes (Petska 1982a, p. 9). Of the 28,000 private foundations identified for 1979, IRS data indicate that some 27,000 were private nonoperating foundations (Petska 1982a, p. 23, table 9). In contrast, the Foundation Center estimated that there were only about 22,000 private nonoperating foundations in 1979 (*Foundation Directory* 1981, p. vii). Available data do not allow a precise determination of the reason for this discrepancy; thus it is impossible to determine how closely the IRS data on private foundations corresponds to the universe of private nonoperating foundations. Table 7.2 presents the size distribution of private nonoperating foundations, as defined by the IRS. Probably the most striking aspect of the table is the uneven distribution of assets among these foundations. Over half the foundations had less than $100,000 in assets; this group together accounted for only about 1 percent of total assets. At the other end, the largest 490 foundations (1.7 percent of the total) had 65 percent of total assets. A small minority of foundations thus accounted for the bulk of foundation assets.[6]

In order to suggest the areas of philanthropic activity in which foundations are involved, table 7.3 provides a breakdown of the number and assets of private foundations by major activity in 1974. Both operating and nonoperating private foundations are included in this tabulation. Of the

Table 7.2 **Number and Assets of Private Nonoperating Foundations, 1979**

Asset Class[a] ($ thousands)	Number of Foundations	Percentage of Total	Total Assets[b] ($ millions)	Percentage of Total
Zero or not reported	1,444	5.3	59	0.2
Under $25	8,092	30.0	98	0.3
$25 under 100	5,598	20.8	331	1.0
$100 under 500	6,383	23.7	1,466	4.4
$500 under 1000	1,961	7.3	1,276	3.9
$1000 under 10,000	2,927	10.9	7,670	23.3
$10,000 under 50,000	457	1.7	7,847	23.8
$50,000 or more	109	0.4	14,219	43.2
TOTAL	26,970	100.0	32,965	100.0

Source: Petska 1982a, p. 24, table 10.
[a]Market value.
[b]Book value.

6. The difference in asset sizes for the largest foundations identified by tables 7.1 and 7.2 appears to be due to the use of market value of assets in table 7.1 compared to book value in table 7.2.

Table 7.3 **Private Foundations by Type of Activity, 1974**

Major Activity	Number of Foundations	Total Assets ($ millions)	Assets as Percentage of Total	Assets of Operating Foundations as Percentage of Class
Religious	2,884	1,035	4.1	2
Schools, colleges	4,049	2,556	10.0	6
Cultural and historical	1,051	1,586	6.2	26
Other instruction and training	265	191	0.7	56
Health services	1,246	1,114	4.4	24
Scientific research	214	175	0.7	54
Business and professional	51	3	0.0	—[a]
Employee or membership benefit	87	20	0.0	—[a]
Sports, athletic, recreational, or social	191	116	0.5	7
Youth	457	217	0.9	9

Conservation, envronmental or beautification	160	300	1.2	55
Housing	112	129	0.5	63
Inner city or community	221	77	0.3	—[a]
Civil rights, litigation	57	38	0.1	—[a]
Other activities directed to individuals	746	2,380	9.3	5
Activities directed to organizations not elsewhere classified	12,148	14,715	57.7	1
Other purposes	174	95	0.4	29
No activity reported	2,748	760	3.0	5
TOTAL[b]	26,889	25,514	100.0	6

Source: U.S. Internal Revenue Service, *Statistics of Income—1974–1978, Private Foundations* 1981,pp. 25–26, table 1.

[a]Not reported separately.

[b]Total includes foundations engaged in farming activities, not shown separately.

specified activity areas, foundations accounting for 10 percent of total assets were devoted to the support of schools and colleges. Foundations with another 6 percent of assets were concerned with cultural and historical purposes, including museums and libraries. Foundations with 4 percent of assets had religious aims. By far the largest number of foundations, representing 58 percent of total private foundation assets, fell into the residual category, "activities directed to organizations not elsewhere classified." This reflects the generality of purpose with which most of the largest foundations were established—a generality that has allowed their trustees and directors considerable latitude to direct grants over time. Operating foundations constitute a significant part of several categories although they account for only a small portion of total private foundation assets. In the housing, other instruction and training, conservation and environmental, and scientific research classes, operating foundations accounted for over half of total assets.

7.2 Tax Treatment of Foundations

Few areas of tax policy have aroused more heated debate than the tax treatment of private foundations. As it developed in the early twentieth century, the legal form of the foundation received several distinct advantages: it could accumulate income without taxation, it could operate in perpetuity subject to the most general stated objective, and (after 1917) individuals making contributions to it could deduct those contributions in calculating their income taxes.[7] These advantages obviously gave foundations considerable autonomy and freedom from the hand of government. This autonomy has been defended as essential to the basic function of foundations in society. Stating that foundations offer a vital independent source of support for new ideas, proponents have argued that the taxation and regulation of foundations should be kept to a minimum.[8]

The special treatment of foundations has also received considerable criticism, and this opposition is apparent in the history of tax legislation regarding foundations. In 1915 the Walsh Commission attacked the concentration of wealth and influence in foundations and recommended limitations on their size, autonomy, and lifetimes (Freemont-Smith 1965, p. 51; Karl and Katz 1981, p. 249). Suspicion of foundations rose during the 1940s as foundations grew and abuses by foundations were made public. It was apparent that some donors derived economic benefit from establishing foundations. By making gifts of nonvoting stock or retaining control of the foundation, a donor could receive an immediate tax deduction

7. See Freemont-Smith (1965) for a discussion of the legal status of foundations, in particular the cy pres doctrine related to the foundation's objective.

8. See, for example, statements by Brewster quoted by Simon in U.S. Congress, Senate, Committee on Finance 1973 p. 179, or Ture and Feulner in Butler 1980.

without relinquishing control of a family business, for example. Or a donor could use his control to have the foundation make favorable grants or loans. In 1950 Congress passed a tax on the unrelated business income as well as restrictions on deferral of charitable gifts and transactions between donors and foundations. Congress showed further disfavor toward private foundations in 1964 by giving preferential tax treatment to "public charities"—organizations receiving "a substantial part" of their support from the public. The limit on charitable contributions to such public charities was raised from 20 to 30 percent of income, but the limit on gifts to private foundations remained at 20 percent. The justification given for this discrimination was the delay that commonly occurred between the establishment of a private foundation and actual grant-making activity (Nielson 1972, pp. 372–73; Freemont-Smith 1965, p. 160). A special Treasury study undertaken about this time confirmed that many private foundations did in fact pay out very small proportions of their assets. Table 7.4 presents a tabulation based on that study. It shows that over 9 percent of private foundations paid out 1 percent or less of their assets in 1962. To what extent these low rates of payout were due to a deliberate policy of capital accumulation or to the practice of some foundations to hold low-yield company stock is unclear.[9]

By 1969 there was strong sentiment in Congress to restrict private foundations further. Not only were the low payout rates a source of concern, there were also continuing problems with donors' attempts to control and manipulate foundations for personal gain (Nielson 1972, p. 373). According to foundation critic Congressman Wright Patman, foundations had by means of their tax exemption become "perverted into a vehicle for institutionalized, deliberate evasion of fiscal and moral responsibility to the nation" (Nielson 1972, p. 9).

As a result of concerns such as these, Congress enacted a set of fundamental changes in the tax treatment of private foundations as a part of the Tax Reform Act of 1969. The act provided for the first time a definition of private foundations. They were defined as nonprofit charitable institutions *other than* operating charitable organizations (such as churches, schools, hospitals, and the like), charitable organizations with broad-based public support, organizations supporting any of the above, or organizations that test for the public safety.[10] The act contained four sets of provisions related to private foundations. First, it established a minimum rate of payout or distribution of grants as a percentage of investment assets. After a phase-in period for existing foundations, the minimum

9. Worthy (1975, p. 244) states that foundations with major holdings in one corporation experienced lower rates of return.

10. *Internal Revenue Code* 1982, sec. 509(a). Broadly based organizations were those receiving over a third of their income from the general public in contributions, sales, or membership fees and less than a third from investment or unrelated business income.

Table 7.4 **Percentage Distribution of Private Foundations by Payout Rate and Asset Size, 1962**

Ratio of Grants to Book Net Worth (percent)	Total	Asset Size: Under $100,000	$100,000 to 1,000,000	$1,000,000 10,000,000	Over $10,000,000
0 to 1	9.2	11.8	5.7	2.5	5.5
1 to 3	9.9	8.2	12.8	11.4	8.5
3 to 6	18.9	11.6	28.9	35.4	40.2
6 to 10	12.3	8.2	17.5	21.5	26.8
Over 10	47.6	57.5	33.8	27.8	18.3
Incomplete information	2.1	2.7	1.2	1.5	0.6
TOTAL	100.0	100.0	100.0	100.0	100.0

Source: Testimony of H. Lawrence Fox in U.S. Congress, Senate, Committee on Finance 1974a, pp. 146–47. Based on Treasury Department Survey of Private Foundations (U.S. Congress, Senate 1965, p. 87).

payout rate was to be the greater of the foundation's actual investment income and a predetermined rate, originally set at 6 percent. This provision was a straightforward remedy for what were seen as insufficiently low rates of distribution by some foundations, as noted above. If funds were put into foundations but never expended for charitable purposes, many felt that it was difficult to justify the deduction for the original payment. The act's second provision was to impose an excise tax, originally at a rate of 4 percent, on the investment income of private foundations. The third provision that affected private foundations did so indirectly. This percentage-of-income ceiling on deductible contributions was raised from 30 to 50 percent for exempt organizations other than private nonoperating foundations; the percentage applying to private foundations remained at 20 percent. In addition, gifts exceeding the 20 percent limit were not eligible for carryover, and gifts of appreciated assets to private foundations were reduced by the capital gains exclusion rate as applied to the appreciation.[11]

Finally, the 1969 act imposed a set of regulatory measures intended to limit the potential for abuse by donors. Most important, that law prohibited "self-dealing" transactions between a foundation and its substantial donors and their families, including such transactions as loans, employment, purchases, or transfers of property. Previously such transactions were permitted if the donor and foundation acted independently and if the terms were no more favorable than could be obtained on the open market. This "arms-length" criterion had been difficult to enforce, however.[12] Next, the act limited a donor's power to maintain control over a foundation through the transfer of company stock. According to the act, a private foundation together with its major donors could hold no more than 20 percent of the voting stock of a corporation. Phase-in periods were allowed for foundations to divest themselves of any excess. Another provision required foundations to verify that grants to other foundations or to nonexempt organizations were actually used for their stated purposes. In addition to these provisions, private foundations were limited in their ability to make risky investments, participate in politics, make grants to individuals, or engage in nonexempt activities.[13] Taken together, these provisions of the Tax Reform Act of 1969 constituted a sweeping change in the tenor and substance of tax law regarding foundations. Even so, they

11. For a description of these provisions, see U.S. Internal Revenue Service, *Statistics of Income—1974-1978, Private Foundations* 1981, p. 5, or *Foundation Directory* 1981, p. xii.

12. *Internal Revenue Code* 1982, sec. 4946 specifies those disqualified from making such transactions. For a comparison of the rules on self-dealing before and after the 1969 act, see U.S. Internal Revenue Service, *Statistics of Income—1974-1978, Private Foundations* 1981, pp. 5-6.

13. See Labovitz 1974, pp. 64-71; U.S. Internal Revenue Service, *Statistics of Income—1974-1978, Private Foundations* 1981, pp. 5-7; or *1980 U.S. Master Tax Guide* (1979, pp. 192-94) for more detailed descriptions of these provisions.

are less stringent than some proposals, such as a provision rejected by the Senate to place a forty-year limit on the lives of private foundations (Council on Foundations 1977, p. 1559). The effects of these changes are the principal topic in section 7.3 below.

Since 1969 there has been some easing in the tax provisions related to private foundations. In 1976 the fixed portion of the minimum payout rate was lowered from 6 to 5 percent, and in 1981 the requirement that the payout rate meet or exceed the actual rate of return on investments was dropped, leaving a simple minimum payout rate of 5 percent. The excise tax on investment income also was reduced in 1978 to 2 percent.[14] Recently, proposals for more favorable treatment of private foundations have received increasing attention. Hearings in 1983 covered such possible changes as repeal of the 2 percent tax and easing of the divestiture rules.[15] Also under consideration was a proposal to end discrimination against private foundations in the deduction ceiling and rules concerning gifts of appreciated assets.[16]

As the law stood following the 1981 tax act, the rules governing private foundations could be quite important in the contribution decisions of some taxpayers. A donor's gift would generally fall under the private foundation provisions as long as he or his appointees retained control over the disposition of funds after the gift was credited. A donor could obtain a higher limit on gifts (30 percent) by giving up some control and establishing a support organization directed jointly by representatives of the donor and a charity.[17] In order to have the maximum deduction limits apply, a donor would have to relinquish control over the funds at the time of the gift; he would have to be content to influence the use of his contribution through a restricted endowment fund or recommendations to the charitable organization. For a class of large donors, however, the control available through the foundation form makes other forms of giving much less attractive. Important questions for tax policy concern the effect of these provisions on the creation of new private foundations, on the support of existing foundations, and on charitable giving in general. The following section addresses these questions.

7.3 The Impact of the 1969 Tax Reform Act on Foundations

Called "the most far-reaching legislation affecting private philanthropy in our two hundred-year history" (Worthy 1975, p. 232), the Tax Reform Act of 1969 has elicited widespread opposition among spokesmen for

14. See *Foundation Directory* 1981, pp. xii, 12, and Sugarman and Feinberg 1981, p. 5.
15. Hearings of the Subcommittee on Oversight of the Committee on Ways and Means covering rules for private foundations were held on 17-30 June 1983.
16. See, for example, "Tax Report," *Wall Street Journal,* 25 May 1983, p. 1.
17. See *Internal Revenue Code* (1982, sec. 509(a)(3)) or Sugarman and Feinberg (1981, pp. 8-11) for restrictions regarding support organizations.

foundations amid predictions of irreparable harm. Taggart stated ominously following the bill's passage: "The bell may well have faintly tolled for the private foundation; it is now to be found only in captivity and there are strong doubts about its ability to reproduce" (Taggart 1970, p. 63). Butler (1980, p. 14) agreed, saying the act will "jeopardize the existence of foundations."

In order to assess predictions such as these, it is useful to consider two sets of influences likely to have emanated from the 1969 act. First, the act's provisions are likely to affect the operation of private foundations, from its investment policy to its policies for making grants. Second, one would expect the act's provisions to affect the attractiveness of foundations as a vehicle for individual contributions or bequests. To the extent that the act's new restrictions lessen the attractiveness of the private foundation in relation to other means of giving—trusts or direct gifts to charities—it is reasonable to expect some substitution in favor of other forms. It is also possible that increases in other forms of giving will not compensate and that overall charitable giving will decline. Needless to say, effects on the operation of foundations and effects on contributions to foundations may also interact. Reductions in gifts may affect grant-making and investment decisions; restrictions on business dealings may affect the establishment of foundations. At the outset, it should be emphasized that as yet there exists little empirical investigation of these effects. What follows is a description of the available data relevant to the impact of tax law, and the 1969 law in particular, on foundations. The primary pieces of data relate to payout rates, other effects on foundation operations, donor support, and overall growth.

7.3.1 Payout Rate

A central pillar of the 1969 legislation was the requirement that private foundations distribute some minimum percentage of their assets annually. The provision arose out of concern that the immediate charitable deductions allowed at the establishment of a foundation might not be matched by actual grants to operating charitable organizations until much later. As Steuerle (1977, p. 1665) has pointed out, much of the discussion over this payout requirement has focused on the question of what rate would be appropriate, considering the investment opportunities open to foundations.

Probably the most useful question that can be posed in assessing the impact of the provision is whether the requirement actually increased payout rates. Since payout rates may be influenced by the rate at which contributions are received as well as by the performance of portofolios, however, it is impossible to isolate the requirement's independent effect. For example, Labovitz found that the median rate of return received by a sample of foundations fell between 1967 and 1970 for each asset group observed. As he suggests, these movements appear to be largely the effect of poor stock market performance (Labovitz 1974, pp. 89–92). In another analysis using a sample of 326 large foundations, Cushman (1979, pp. 155–56 table 6.3) found that the average payout rate rose from 4.2 to 6.6 percent between 1968 and 1973. Table 7.5 presents aggregate data on foundation distributions for various years, using two different series of data. The first data set covers all foundations. The second includes only a sample of the largest ones. The former shows a general rise in payout rates from the early or mid-1960s to 1979 while the second does not suggest any clear trend. Comparisons over time such as those in table 7.5 are hampered, however, because the calculated rates are based on different sample sizes, the smaller samples tending to be dominated by the largest foundations. In order to assess the implication of differing compositions of small and large foundations, it is useful to turn briefly to a consideration of the effect of asset size on rates of distribution.

The payout rates in the IRS sample covering all foundations are slightly higher than that based on the sample of large foundations. Most likely this difference reflects the generally higher payout rates for small founda-

Table 7.5 Payout Rates for Foundations Based on Two Data Series (dollar amounts in millions)

	IRS Information Returns (990-PF): All Private Foundations			
Year	Number of Foundations[a]	Total Assets[b]	Contributions Paid	As Percentage of Assets
1962	14,865	$16,262	$1,012	6.2
1974	26,889	n.a	1,953	n.a.
1977	27,691	34,817	2,289	6.6
1978	29,659	36,735	2,764	7.5
1979	27,980	44,648	2,801	6.3
	Foundation Center Surveys of Large Foundations			
Year[c]	Number of Foundations[d]	Total Assets[b]	Grants	As Percentage of Assets
1965	6,803	$19,927	$1,212	6.1
1969	5,454	25,181	1,513	6.0
1972	2,533	31,510	1,548	4.9
1975	2,818	28,635	1,808	6.3
1977	3,138	32,359	2,062	6.4
1979	3,363	38,553	2,365	6.1

Sources: Petska 1982b, p. 25; *Foundation Directory* 1967, p. 15; 1971, p. xi; 1975, p. xvi; 1977, p. xvii; 1979, p. xiv, 1981, p. vii.

[a]Includes non-grant-making foundations.

[b]Market value.

[c]Years covered by surveys are approximate.

[d]Includes all foundations meeting specific size criteria in each year.

tions, as indicated in table 7.6 for 1979. Expressed as a percentage of the book value of assets, payout rates ranged from 74 percent for foundations with less than $25,000 in assets to 6.5 percent for foundations with assets over $50 million. These payout rates correspond closely to the rates at which contributions were received. The implication of these differences, noted by Petska (1982a, p. 14), is that a percentage payout requirement such as that in the 1969 act poses a more serious constraint on large foundations than small ones, because of the latter's greater access to annual contributions as a source of funding. This suggestion finds support in table 7.7, which gives the required and actual distributions. While foundations in the lowest asset class distributed over three times what they were required to, the grants of the largest foundations exceeded the required amount by only 11 percent. To the extent that the payout requirement actually constrains the behavior of any foundations, therefore, its effect is most likely to be felt among the largest foundations, those least likely to receive a large portion of their incomes in the form of contributions.

Any increase in the payout rate, other things equal, will reduce the rate at which foundation assets grow. One frequently expressed concern among critics of the 1969 payout requirements is that they would force managers to "invade corpus" and distribute some portion of assets annually. Alternatively, foundations would be forced to switch away from growth stocks paying few dividends to assets offering higher interest rates but no growth opportunities. Indeed, one argument for payout requirements has been that foundations should not grow over time unless they

Table 7.6 **Gifts Received and Grants Made by Private Foundations, 1979**

	Gifts Received		Gifts Paid Out	
Asset Size[a] (thousands)	Total ($ millions)	As Percentage of Assets[b]	Total ($ millions)	As Percentage of Assets[b]
Zero or not reported	8	13.4	16	26.6
Under $25	78	77.6	75	74.2
$25 under 100	70	20.4	59	17.3
$100 under 500	227	13.6	193	11.5
$500 under 1,000	145	10.9	145	10.9
$1,000 under 10,000	682	8.3	716	8.7
$10,000 under 50,000	562	6.7	652	7.8
$50,000 or more	510	3.5	946	6.5
TOTAL	2,282	6.6	2,801	8.1

Source: Petska 1982a, p. 16, table 2.
[a]Market value.
[b]Book value.

Table 7.7 Required and Actual Distributions for Exempt Purposes for Nonoperating Foundations, 1979

Asset Class	Number of Foundations	Required Distribution[a] ($ millions)	Actual Distribution ($ millions)	Required as Percentage of Actual
Under $100,000[b]	15,833	83.4	279.5	29.8
$100,000 under 1,000,000	7,862	196.9	375.1	52.4
$1,000,000 under 10,000,000	2,761	559.3	786.5	71.1
$10,000,000 or more	514	1610.7	1791.6	89.9
TOTAL	26,970	2450.3	3233.3	75.8

Source: Petska 1982a, p. 26, table 12.
[a]"Distributable amount."
[b]Includes foundations with assets not reported.

continue to receive contributions. As Steuerle has noted, the real value of foundation assets will grow as long as the payout rate is not more than the sum of the real rate of return and the growth rate of assets due to new contributions (Steuerle 1977, pp. 1673–75.). In fact, the real value of private foundation assets has increased. Converting the asset values shown in table 7.5 to 1972 dollars shows an increase in real market value from $23.0 billion in 1962 to $27.4 billion in 1979 (Petska 1982b, p. 25). To summarize the evidence on payout rates, it seems likely that the law has been a binding constraint for some, mostly larger, foundations. The time-series evidence on payout rates is inconclusive, however, because the Foundation Center's sample was reduced between 1969 and 1972, raising the average size of the foundations included, and thus tending to lower observed payout rates. In any case, there is as yet no clear evidence to suggest that the payout requirement—in combination with asset yields and contributions received—has led to a decline in real asset values.

7.3.2 Formation of and Contributions to Foundations

Probably the most important measure of the impact of the 1969 legislation on private foundations is the law's effect on their creation and support by individual donors. The predictions of doom for foundations would indeed come about if the new restrictions on foundations caused potential donors to make other kinds of charitable gifts or forego making contributions altogether. In his testimony before the Finance Committee in 1973, John Simon argued that the 1969 lelgislation had reduced the birth rate of new foundations. He presented evidence that the number of new private foundations appearing annually had fallen by over half between 1969 and 1973 (U.S. Senate, Committee on Finance 1973, pp. 173–75).

In order to examine the possible effect of the 1969 act on the creation of new foundations, tables 7.8 and 7.9 present information on the number of foundations established over time. Table 7.8 displays the year of establishment for two samples of large foundations for 1969 and 1979. It shows that the number of births in the 1970s was only a third the level of the 1960s. However, it also shows that, in both samples, the 1950s was the most active period for the creation of large foundations: the number of foundations established in the 1960s was 40 percent less than the level for the 1950s. Table 7.9 shows, in the last two columns, the yearly average of the number of foundations receiving their tax exemption and their assets as of 1974 over several different periods from 1920 to 1974. In agreement with table 7.8, the period 1950–59 represented the most active (as measured by assets) period for the establishment of foundations. By this measure the decade of the 1960s was nearly as active, but the figures for that decade include institutions that had previously been established without securing official tax-exempt certification.[18] From 1970 to 1974, foundations with average assets of $421 million have been established annually,

Table 7.8 **Period of Establishment of Large Foundations**

	1969 Sample		1979 Sample	
Period	Number	Percentage	Number	Percentage
Before 1900	18	0.3	25	0.8
1900–1909	16	0.3	17	0.5
1910–1919	75	1.4	58	1.7
1920–1929	157	2.9	136	4.1
1930–1939	259	4.8	176	5.3
1940–1949	1134	20.9	625	18.8
1950–1959	2546	46.8	1272	38.3
1960–1969	1231	22.6	759	22.8
1970–1979	—	—	255	7.7
	5436	100.0	3323	100.0

Source: Foundation Directory: 1969 Sample: 1971, p. x; 1979 Sample: 1981, p. xiv.

Note: Samples for tabulation consist of all foundations meeting specific size criteria in each year. For the 1969 sample, foundations with grants of $25,000 or more or with assets of $500,000 or more were included (*Foundation Directory* 1971, p. vii). For the 1979 sample, the comparable amounts were $100,000 in grants or $1 million in assets (1981, p. vii).

18. See U.S. Internal Revenue Service, *Statistics of Income—1974–78, Private Foundations* 1981, p. 24, for an explanation of the process by which institutions were granted tax-exempt status.

Table 7.9 **Number and Assets of Foundations by Year in Which Tax Exemption Was Obtained**

	Total for Period		Annual Average for Period	
Period	Number of Foundations	Assets ($ millions)	Number of Foundations	Assets ($ millions)
1920–1939	401	3,784	20	189
1940–1949	2,071	4,283	207	428
1950–1959	6,061	7,792	606	779
1960–1969	12,094	7,181	1,209	718
1970	1,247	462	1,247	462
1971	1,092	367	1,092	367
1972	1,081	421	1,081	421
1973	809	475	809	475
1974	856	381	856	381

Source: Internal Revenue Service, *Statistics of Income—1974–1978, Private Foundations* 1981, p. 93, table 18.

much below the rate for the 1950s.[19] To summarize, the decline in the birth rate of new foundations began before the enactment of the Tax Reform Act of 1969 and appears to have accelerated slightly after it. Whether the act had an independent effect on this rate cannot be determined, however, on the basis of existing data. Not only might nontax influences have changed over the period, but some of the decline in the 1960s may have been due to actual or anticipated restrictions on foundations felt during the 1960s. The increase in the percentage limitation for gifts in 1964 was not extended to private foundations, as noted above. In addition, the hearings and reports on foundations may have had an adverse "announcement effect" on new foundations by signaling more stringent regulations to come.

Another deliterious effect seen as a possible result of the 1969 act was a drop in the rate at which individuals contributed to foundations. Labovitz's survey supported this fear, showing that the percentage of foundations receiving any contributions had fallen from 1967 to 1970 and that the average size of contributions had fallen in all but one asset class (Labovitz 1974, p. 99). In an attempt to provide a longer period for comparison, table 7.10 shows gifts received as a percentage of total assets of the large foundations covered in the Foundation Center's periodic surveys. These figures do in fact show a drop in contributions relative to assets between 1969 and 1972 as well as a lower rate of contributions after 1969.

19. Since some foundations created during the 1950s no longer exist, these figures understate the rate of births during that decade.

Table 7.10 **Gifts Received by Large Foundations, Selected Years**

Year[a]	Number of Foundations	Gifts Received ($ millions)	As Percentage of Total Assets
1965	6803	765	3.8
1969	5454	1,152	4.6
1972	2533	734	2.3
1975	2818	946	3.3
1977	3138	1,339	4.1
1979	3363	1,356	3.5

Source: Foundation Directory, various years. See table 7.5.
[a]Year is approximate.

However, this time series is subject to the same kind of bias affecting the comparison of payout rates over time. Because the sample size was reduced after 1969, leaving larger average foundations, one would expect observed contribution rates to be lower. Consequently, these data do not allow a satisfactory test of whether contributions have fallen off as a result of the 1969 tax act. The only comparable data on contributions received over time is Cushman's (1979, pp. 162–63, table 6.4) finding that gifts received by a sample of 326 large foundations fell between 1968 and 1973 from 15.1 to 8.3 percent of total income. The fall in stock prices over this period may have been a significant factor in this comparison, however.

7.3.3 Other Effects

There is some evidence that foundation behavior was influenced in other ways by the 1969 tax act. In general, however, these effects do not lend themselves readily to measurement. Labovitz's (1974) survey results suggest, for example, that many foundations modified their grant making as a result of the act's requirement to exercise "expenditure responsibility" over grants not made to exempt charities. As a result of the requirement, some foundations apparently shied away from making grants to controversial or unusual organizations (pp. 82–85). The survey results also indicate an increase in legal and administrative costs as a result of the act, though these could well have been short-term effects (pp. 78–82).[20] There was little evidence that the requirements to divest certain stock, imposed as they were over a long period, had had much effect by 1970 (pp. 94–98).

One other measure for the cumulative effect of these and other restrictions imposed by the 1969 act is the rate at which foundations terminate operations. Simon presented data to suggest that this death rate had risen

20. Cushman (1979, pp. 166–67, table 6.5) reports for his sample of 326 large foundations that the ratio of expenses to income rose from 7.0 to 12.2 percent between 1968 and 1973.

steeply since 1969 (U.S. Senate, Committee on Finance 1973, p. 174). While this is suggestive, it is difficult to draw any firm conclusions without a longer time series of observations on foundation deaths and births. More generally, it will be impossible to give a full assessment of the effect of the 1969 act without a more complete model of donors and foundations themselves.

7.4 Conclusion

The privileged position of foundations as autonomous, undying, and tax-exempt entities was challenged by a comprehensive set of provisions in the Tax Reform Act of 1969. The bill appears to have been motivated in large part by the perception that, in many cases, the private foundation was "little more than a tax shelter" (testimony by Patricia Senger, U.S. Senate, Committee on Finance 1974b, p. 50). Since 1969 the Congress has softened the restrictions somewhat, but most of the 1969 provisions remain in force. Because of the importance of the 1969 act, analysis of the effect of federal tax law on foundations must focus on the effects of these provisions. The chapter indicates quite clearly, however, that the analysis of these effects is severely hampered by the dearth of useful data for analyzing foundation behavior over time. Although foundation tax forms provide the groundwork for a useful data set, the data in this area remain far less developed than those used in studying other areas of philanthropy.

Based on the fragmentary data presented in this chapter, it appears that the 1969 act was successful in altering some forms of behavior by foundations and their donors without jeopardizing the continued use of the foundation form. Payout rates appear to have increased slightly due to the act. As for contributions to foundations, it is not clear whether they have risen or fallen overall as a result of the 1969 act. It is not clear that the act has reduced the rate at which foundations are established. Nor does the increase in the real value of foundation assets since 1962 suggest that the 1969 act has made foundations a dying breed. Given the available data, it appears indeed that the rumors of their demise may well have been exaggerated.