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From Reform to Retreat

House Committee Caves to Pressure on Foundation Spending Provision

By Rick Cohen

In the wake of the House Ways and Means Committee vote in September weakening the foundation spending reform (Section 105) in the Charitable Giving Act of 2003 (H.R. 7), it may be time to assess the lessons learned for foundations and foundation reformers alike.

The original version of Section 105 contained two provisions of note for generating increased private foundation grantmaking. One consolidated and reduced the excise tax on private foundation investment income from 2 percent to 1 percent. The other excluded foundations' administrative and operating expenses from what foundations count toward their minimum charitable spending requirement (known as "qualifying distributions" or "payout")—an average annual minimum disbursement of 5 percent of foundation assets. The latter might have resulted in freeing up some $3 billion annually in foundation payout that could have been redirected to grants for hard-pressed nonprofits.[1]

Nonetheless, under relentless pressure from the foundation lobby, the Ways and Means Committee modified Section 105 to allow private foundations to count those administrative and operating expenses toward their payout that are "directly attributable to direct charitable activities, grant selection activities, grant monitoring and administrative activities, compliance with applicable federal, state and local law, or furthering public accountability." In addition, the committee "limited" the amount of compensation of foundation executives and board trustees that can be counted toward payout to $100,000 for each person, and limited foundation travel that can be counted toward payout to the costs of regularly scheduled commercial coach airfare.

1. NCRP issued three research reports over the summer studying the original version of Section 105 of H.R. 7. These can be accessed by visiting www.ncrp.org or calling (202) 387-9177.

Rick Cohen

So what's wrong with the compromise version of Section 105? Plenty, and even the powerful foundation lobby knows it.

Welcome to Rube Goldberg: Remember the wacky, elaborate contraptions that cartoonist Rube Goldberg "invented" to carry out mundane life tasks like cleaning windows, sharpening pencils and dodging bill collectors? Goldberg's contrivances "worked," but in real life—and in public policy—unnecessary complexity doesn't, and it's actually harmful. The rationale for Section 105 tracks back to a 2001 recommendation of the bipartisan Joint Committee on Taxation that simplifying the rules for foundations, particularly with regard to the calculation of the two-tiered foundation excise tax, would increase grantmaking. Simplification would also reduce the oversight burden on the IRS. Regrettably, the revised Section 105 passed by Ways and Means isn't simplification, but the exact opposite, requiring new record keeping and new oversight for determining the accuracy of foundations' classification of grant-related and charitable administrative expenditures.

Déjà Vu All Over Again: That's what Yogi Berra might have said about the H.R. 7 compromise. In the 1980s, there was a requirement (dubbed the 0.65 rule) that foundations classify their expenditures between grant-related administrative expenditures and others, and only count the grant-related expenditures toward their required payout. Foundations also had to cap their grant-related administrative expenses at 0.65 percent of assets. In 1990, the Treasury Department studied

foundations' compliance with the rule and discovered that just about all of them got it wrong, either attributing too many administrative expenses or too few to their qualifying distributions. Foundations went through the motions of compliance, but most knew that the lack of government oversight made the process relatively meaningless. The 0.65 rule didn't work, so Treasury and the foundations scrapped it. Now, thanks to the new version of Section 105, the unworkable rule is back—except it lacks the previous limitation of administrative expenses to 0.65 percent of assets. So, the likely result will be a lot of gnashing teeth and accounting turmoil by foundations trying to do the right thing, and still getting it wrong.

Less Is Really Less: Architect Mies van der Rohe, an advocate of design simplicity, sermonized that "less is more." But the new Section 105 will likely mean less grantmaking. Cutting out administrative and operating costs from foundation payout while keeping the 5 percent minimum charitable spending requirement would clearly have meant more grant money for nonprofits. But with the new proposal now expressly permitting foundations to count administrative costs toward payout, many foundations will likely accept the invitation to count administrative costs that they had previously excluded from their payout calculations. This is the likely result, in the same way that most foundations use the 5 percent minimum payout requirement as a planning tool for making 5 percent their payout ceiling—instead of the floor that it was intended to be. At this time, less than half of foundations' administrative and operating expenditures are counted toward qualifying distributions. With the altered language of H.R. 7 asking for an accounting of grant-related and other expenditures, the incentive will be to count, meaning more administrative costs and less grant money in private foundations' payout.

The Trustee Fee Loophole: Georgetown's Center for Public and Nonprofit Leadership just published a devastating study (available at www.ncrp.org) on the egregious practices of some foundations paying their board members outlandish fees (see story, page 11). Rather than banishing the practice altogether, the study's authors recommended limiting trustee fee compensation to $8,000 annually (plus expenses). So what did the foundation lobbyists achieve with the revised Section 105? An invitation for foundations to count up to $100,000 annually in compensation payments to each of their trustees toward their charitable distributions. If some foundations had been concerned that their salary-like payments to board members might have been excessive, they won't have to worry any longer once the Section 105 compromise is enacted—at least they won't have to worry to the tune of $100,000. And that doesn't even count the payments that some foundations make to trustees for their professional services (such as legal, accounting, etc.), which in any other nonprofit would look an awful lot like self-dealing. Excluding from payout every single cent of payments to trustees might have been the simplest way to go, but the so-called compromise went the other way.

Less Accountability: A foundation lobby spokesperson acknowledged to the *San Jose Mercury News* that some foundations might try to "game" these new foundation rules and abuse them. The incentive to count every single nickel of administrative costs as grant-related is one obvious area. The hint to foundations to ratchet up payments to board members is another. The Charitable Giving Act was meant to increase philanthropic grantmaking (and charitable giving overall), and as a byproduct of Section 105 to enhance philanthropic accountability. The compromise manages to achieve neither more grants nor enhanced accountability.

Spinmeisters: One frequently quoted foundation lobbyist was cited in *The Chronicle of Philanthropy* repeating the charge that the origi-

The compromise [version of Section 105] manages to achieve neither more grants nor enhanced accountability.

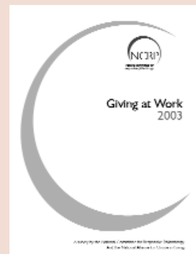
nal H.R. 7 implied that foundations are "only supposed to write checks." Who said foundations are supposed to only write checks? No one we know. The other frequent charge was that this minor change in foundation rules would drive organized philanthropy out of business, that no one would want to start up new foundations and that existing foundations would be forced to spend down to zero. Oh? The original Section 105 would have increased foundation spending an average of only about 0.4 percent of assets annually. The misstatements and fear ginned up by professional lobbyists are examples of spin, designed to hammer a theme chosen for its effectiveness rather than its connection to reality. This dumbing down of the philanthropic debate is meant to wipe out (or as a foundation lobby spokesperson said in a quote printed in *The Wall Street Journal*, to "napalm") the opposition rather than to elevate and advance the public dialogue.

Scare Tactics: Somehow, many nonprofits have gotten it into their heads that speaking out on foundation payout—or almost any other issue of foundation behavior—will get them defunded. NCRP has gotten scores of troubling messages from nonprofits to the effect that "we can't say anything, but we're glad you're doing what you're doing." Perhaps the aftermath of H.R. 7 will revive the democratic debate that energizes nonprofit voices about their stake in the uses and misuses of philanthropic capital.

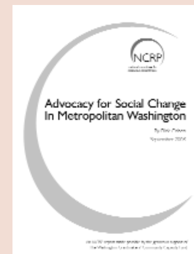
At press time, H.R. 7 (including the altered Section 105) had passed the House and awaits reconciliation with the version of the bill passed by the Senate. Maybe the House/Senate conferees will recognize that the Section 105 compromise might actually be worse than doing nothing at all on foundation charitable spending, though losing the reduction and consolidation of the foundation excise tax would be disappointing. Nonetheless, it is difficult to imagine that many people, no matter where they stood on the original language of Section 105, won't see this lobbyist-crafted Rube Goldberg mishmash for what it really is: a disappointing setback to the twin goals of increasing foundation grantmaking and enhancing foundation accountability.

Rick Cohen is executive director of the National Committee for Responsive Philanthropy (NCRP). NCRP was founded in 1976 and is dedicated to helping the philanthropic community advance the traditional values of social and economic justice for all Americans. Committed to helping funders more effectively serve the most disadvantaged Americans, NCRP is a national watchdog, research and advocacy organization that promotes public accountability and accessibility among foundations, corporate grantmakers, individual donors and workplace giving programs. To obtain more information on NCRP or to join, please visit www.ncrp.org, call (202) 387-9177 or use the enclosed membership form.

New NCRP Reports Offer Solutions to Improve Philanthropy



Giving at Work 2003, NCRP's latest report on trends in workplace giving programs, reveals that alternative funds continue to grow as the United Way shifts its focus toward wealthier donors.



Advocacy for Social Change in Metropolitan Washington, released in September 2003, maps the funding landscape for nonprofits engaged in local and regional public policy advocacy in the metropolitan Washington area.

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