

# PRIVATE FOUNDATIONS AS INVESTORS AND DISTRIBUTORS OF TAX-EXEMPT CHARITABLE DOLLARS, 1974-87

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Through an examination of financial data and legislative and economic forces from 1974-87, this analysis discusses trends within the area of private foundations. It begins with a profile of foundation data, follows with an explanation of the role of foundations in society, and describes this role in light of the economic theories and legislative changes that relate to foundations. It focuses particular attention on the changes following the passage of the Economic Recovery Act of 1981. The Act changed the way that foundations calculate the required charitable payout amount. Although the Act resulted in lower charitable distributions in the short-run, in the long-run charitable distributions have increased. This paper analyzes the changes in charitable distributions and assets and considers them in light of investment returns. It examines charitable payout rates, rates of return, income yields, and the rates of changes in total distributions and assets. By so doing, it seeks to better understand the decision-making behavior of the different sizes of foundations.

## A FOUNDATION PROFILE

Almost 36,000 private foundations in 1987 represented approximately 10 percent of all tax-exempt nonprofit organizations recognized under section 501(c)(3) of the Internal Revenue Code. Of these organizations, foundations held approximately 15 percent of assets. All of them distributed over \$8 billion in 1987 (current dollars), mainly in the form of grants to individuals and other nonprofit groups, in order to support areas such as research, education, community needs, and cultural programs.

Foundations typically originate from a single contribution by a wealthy individual, family, or sometimes a corporation. They differ from other 501(c)(3) tax-exempt organizations in their sources of financial support. The other 501(c)(3) tax-exempt organizations, hereafter referred to as "nonprofit charitable organizations," include groups such as hospitals, educational institutions, religious groups, and social welfare agencies. They typically rely on funding received from a wide variety of public sources. These groups tend to

impact society through funds and public donations realized in one year and then utilized in the same or next year. Foundations, on the other hand, typically receive donations from one wealthy individual or family and then make distributions from an endowment that grows over time.

In addition to their base of support, foundation donors uniquely benefit by maintaining control, in part, over the investment and distribution of the foundation's money. Current Federal tax law requires that a private foundation fulfill a "payout requirement" by charitably distributing a fixed percentage of its asset base, now 5%, each year. In order to fund charitable activity, most often in the form of grantmaking, a foundation invests its endowment in order to realize a return on assets that will fulfill the payout requirement and often enable the foundation to grow and exist permanently.

In 1987, there were approximately 32,700 "non-operating" foundations. The analyses in this paper will focus only on "nonoperating" private foundations, as opposed to "operating" private foundations. Non-operating foundations comprise approximately 91 percent of the foundation population in number and over 90 percent in fair market value of assets. The two types of foundations function differently.[1] In 1987, these nonoperating foundations held \$103.2 billion in fair market value of assets [2] and distributed \$7.4 billion to charitable purposes (current dollars). Interestingly, less than .5 percent of all foundations, those with fair market value of assets equal to or greater than \$100 million, held 52 percent of total assets. The smaller foundations, those with less than \$1 million in assets, accounted for 80 percent of the total number but held only 5 percent of the total assets.

From 1974 to 1987 foundations increased charitable distributions by 45 percent. Since 1979, the first year for which fair market value data were available, assets increased by 63 percent. The Gross National Product (GNP) increased by only 21 percent during the 1979-87 period. To more closely analyze this period, from 1979-82, foundation fair market value of assets in-

creased by 4 percent, while the GNP declined 1 percent. Then, from 1982-87, foundation assets grew 56 percent--a large increase in comparison to a 22 percent growth rate in the GNP. These figures indicate a significant level of growth for the foundation sector during this time period. (All dollar amounts, rates, and percent changes throughout the text, unless otherwise indicated, are calculated using 1982 constant dollar figures.)[3]

## THE ROLE OF PRIVATE FOUNDATIONS

On account of their important charitable initiatives and resources, foundations represent an example of pluralism in American society. Pluralism illustrates the ability of private forces, supplementing the role of government, to effectively impact society. Donations to establish or support foundations qualify for a federal income tax-deduction of up to 30% of the donor's adjusted gross income. (This compares to 50% for donations to operating foundations and to other nonprofit charitable organizations.) In essence, the government grants donor deductibility and sacrifices tax revenue on foundation income in exchange for foundation charitable dollars and initiatives. Technically, when a foundation originates, the donor receives an immediate tax deduction for the entire amount used to establish the foundation. Although the donation grows as a charitable endowment for the future, the foundation gives only a percentage of the deductible amount to charitable causes each year. And, since the individuals controlling the foundations indirectly possess the power to influence social programs, policy, and research, there are those who may view foundations with a degree of skepticism and a feeling that, along with the benefits foundations provide, they not only represent pluralism in society, but also elitism. Since the base of financial support for a foundation is relatively narrow, the government recognizes that a greater potential for abuse exists, and therefore increases its measures of regulation. On account of this, policymakers attempt to balance the regulation of foundations with a respect for the private ownership of foundation assets and the important charitable distributions given to society.

## ECONOMIC ANALYSIS

Private foundations represent a unique entity within the framework of the American market economy. The economics of foundation behavior differs from that of

both profit-making firms and other nonprofit organizations. Foundations possess a great deal of freedom in the distribution and management of their money, and, unlike profit-making organizations, they do not always face the same incentives for efficiency that exist in a totally competitive market environment.

In a manner similar to for-profit organizations and different from many other nonprofit groups, foundations devote a considerable amount of attention to investment management. This especially applies to the larger foundations, which tend to operate with the goal of a permanent existence attainable through capital appreciation of the endowment. These groups also possess the resources necessary to devote to skillful investment and risk management. They do have an incentive to maximize return on investment, since, to successfully meet the payout requirement and avoid an erosion of the endowment, they must realize a rate of return equal to 5 percent plus the rate of inflation. However, unlike for-profit groups, foundations do not distribute dividends or income to owners and shareholders, and thus, are not accountable in this manner. However, they are indirectly accountable to a strong donor desire to perpetuate the endowment of the foundation.

Foundations also differ from for-profit groups and from many nonprofit groups in that they typically do not compete for consumers. On the contrary, consumers (e.g., grant-seekers) usually compete for foundation dollars. An exception to this occurs when several foundations compete to fund a high visibility project. Although foundations do not actively compete in the market, they can act as a constraining force on the nonprofit organizations that they fund. When nonprofit groups compete for foundation dollars, this competition can give these groups an incentive to operate efficiently.

Supply-side economic theories can help to explain the formation and behavior of foundations. These explanations indicate that foundations form and exist due to recognition of a public need for charitable resources and as a response to the pluralistic forces that operate within the American social and political arena.[4] Individuals possess the incentive to form foundations and supply charitable dollars due to a recognition of societal need and a subsequent desire to alleviate this need. The supply explanation also supports the notion that the incentive of tax deductibility influences individuals to

form foundations. Although the tax benefits are not as great as those for donations to other charitable organizations, the donor does benefit by maintaining influence over the investment and use of the charitable dollars. In effect, foundations provide a tax effective manner by which an individual or group of individuals can publicly achieve altruistic goals and impact social policy and programs. It would prove interesting to know the relative importance of each factor for a donor (a supply response to need, a desire for power and prestige, or the incentive of tax deductions) when deciding to form or give to a foundation.

Interestingly, from 1982-87, the number of all foundations increased by 26 percent. This compares to a 6 percent increase from 1974-82. This difference more than likely results from a combination of factors such as the recognition of social need in light of domestic budget cuts during the 1980s, changes in tax-deductibility benefits to donors, the capital gains tax rate, and the 1981 Economic Recovery Act, to be discussed later.

#### **LEGISLATIVE HIGHLIGHTS THROUGH 1969**

By granting tax-exemption to private foundations, policymakers intend that foundations distribute more dollars to society than the cost of the foregone tax revenue. Since foundations function in a unique manner, it becomes difficult to quantitatively ascertain the amount of tax revenue lost. Due to this reason and the power held by foundations, legislative changes since the early 1900's have typically involved the regulation of foundations. In order to best understand the historic complexity of the Federal viewpoint towards private foundations, an examination of important legislative changes relating to foundations follows.[5]

Charitable activity by benevolent organizations similar to present-day foundations began in the mid-to-late 19th century. The Federal government began to grant tax-exempt status to these organizations and tax-deductibility for individual and corporate charitable donations in the early 1900's. These exemptions and deductions resulted, in part, from budgetary pressures relating to World War I involvement. Policymakers expected that these incentives would encourage private philanthropy that would, in effect, replace the need for government funding of certain societal needs.

In 1912, the Walsh Commission conducted a Congressional study to determine the amount and effects of the wealth and power of foundations. The group recommended that foundations distribute all of their income each year, but not pay out amounts in excess of 10 percent of underlying principal or corpus. This recommendation indicates some degree of Congressional intent for foundations to operate, if not in perpetuity, then by an investment strategy that would allow charitable distributions well into the future.

Suspensions began to arise after a gradual observance of abusive activities committed by a small number of foundations. An evolving concern over the freedom granted to foundations led Congress, in 1934, to prohibit foundations from using their money and power to impact political campaigns and/or legislation. Several years later, the Revenue Act of 1943 required that foundations file annual reports and information returns with the IRS. Then, the 1950 Revenue Act outlined "prohibited activities" and imposed regulations on foundations concerning unrelated business income, excess business holdings, excessive accumulations of income, speculative investing, political lobbying, and self-dealing. In 1954, the Reece Committee recommended that foundation existence be limited to 10-25 years and that all income earned be charitably distributed within 2-3 years. Nothing resulted from this and, then, in 1965, the Treasury Department issued a report indicating a greater commitment to eliminating abusive foundation activities rather than to limiting the foundation lifespan.

The 1965 Treasury Department report later resulted in new tax regulations outlined in the Tax Reform Act of 1969. Interestingly, a 40-year time cap on the exempt status of a private foundation was proposed as part of the 1969 Act, but ultimately not included in the passed legislation. Additionally, this Act subjected foundations to an annual 4 percent excise tax on investment income (intended to cover the cost of IRS oversight of foundation activities) and a two-tier system of penalty taxes. The IRS imposed these penalty taxes on the 1950 Revenue Act prohibited activities and on required charitable dollars that foundations failed to distribute by the end of the following return year.

The most significant portion of the 1969 Act was the development of the first charitable payout requirement.

This legislation required that foundations distribute each year an amount equal to the greater of either "adjusted net income" or a fixed percentage of fair market value of assets.[6] The adjusted net income amount basically represents realized income on investments, excluding long-term capital gains. By comparison, the change in assets encompasses both realized and unrealized gains in the endowment. The charitable dollars dispersed in order to satisfy this requirement are called "qualifying distributions."

## THE TWO PAYOUT REQUIREMENTS

The charitable payout requirement from the Tax Reform Act of 1969 tended to restrict the financial independence of foundations and allowed for relatively little financial flexibility over time. Although the Act allowed foundations to legally distribute the required amount by the end of the following tax year, it still indirectly encouraged relatively conservative foundation investment policies. Since foundations wanted to manage investments in order to achieve a return, either realized or unrealized gains, which would result in the lowest possible distribution requirement, the Act, in effect, encouraged relatively conservative investment policies in terms of the portfolio mix and level of risk. In order to maintain its endowment, a foundation typically needed to yield an annual rate of return equal to 6 percent, at that time, plus the rate of inflation. This often proved difficult for many foundations. The high inflation rates during the 1970s also added to concern about a continual erosion of foundation endowments.

In 1976 Congress enacted legislation that lowered one part of the required payout amount by changing the percentage from, in most cases, 6 percent to 5 percent of assets. The reduced rate allowed (some) foundations an added edge in meeting the charitable distribution requirement. Similarly, in 1978, Congress lowered the effective excise tax rate from 4 percent to 2 percent for domestic foundations. This also allowed foundations an additional amount to either distribute or reinvest.

The most significant legislative change, however, came with the passage of the Economic Recovery Tax Act of 1981. This change significantly altered the method by which foundations computed the charitable payout requirement. It eliminated the use of adjusted net income and used only the percentage of investment

assets to compute the required payout amount. Through this Act, policymakers hoped to increase the long-run amount of foundation charitable distributions by allowing foundations a greater opportunity to increase the value of their endowments, thus increasing their giving power.

This change, in effect, increased the fairness of the requirement since a change in assets encompasses both realized and unrealized changes in the endowment, and thus, better measures the entire endowment. In comparison, the calculation based on the adjusted net income measures only realized changes. Before 1981, those foundations earning realized income that exceeded the percentage of assets seemed to be indirectly penalized since the unrealized changes in their endowment were not considered in the computation of the payout requirement. Therefore, the change seemed to create a more favorable investment environment, particularly for the smaller foundations. Smaller foundations tend to hold a greater proportion of fixed income yield investments that earn proportionately high realized income.[7] However, the data indicate that the larger foundations, rather than the smaller, tended to take advantage of the change by distributing proportionately less after 1981 and then, re-investing more. The smaller foundations did not tend to significantly re-adjust their investing and distributing patterns.

In effect, the change ultimately lowered the required payout amount on an aggregate level in the short-run. In 1982 and 1983, respectively, 35 and 32 percent of foundations, especially the larger ones, reacted to the lowered payout requirement by distributing less than what would have been required under the law prior to 1981. Ultimately, then, the new law has helped foundations to increase the long-run value of their assets, therefore increasing long-run charitable giving.

The Act also has positively affected asset growth over time. From 1982 to 1987, total foundation fair market value of assets increased by 56 percent. This compares dramatically to the 4 percent increase between the years 1979-82. Total qualifying distributions increased, but at a slower rate than assets, by 38 percent from 1982-87. This compares to the 5 percent increase in distributions from 1974-82. The data that follows will analyze the effectiveness of the 1981 Economic Recovery Act in achieving the goal of increased long-run foundation distributions.

## THE PAYOUT RATE

To illustrate the charitable distribution trends of private foundations, rates of payout performance were calculated.[8] To calculate the payout rate the amount of (adjusted) qualifying distributions [9] was divided by the amount of the monthly average of investment (noncharitable-use) assets. Figure A displays payout trends from 1974-87. Typically, the payout rate declines as the size of the foundation increases. Smaller foundations tend to give out a larger percentage of their asset base, sometimes to an extent exceeding their return on investments. Larger foundations tend to re-invest proportionately more of their earnings, consequently distributing a smaller proportion to charitable purposes in any given year.

FIGURE A - Payout Rates, 1974-87

SIZE OF (FMV) <sup>1</sup> ASSETS	PAYOUT RATE (Median percentages)					
	1974	1982	1983	1985	1986	1987
TOTAL	8.39	9.69	8.23	7.44	6.87	7.03
<b>Small Foundations</b>						
\$1 under \$100K	10.94	10.67	9.76	8.30	10.23	9.63
\$100,000 under \$1M	7.25	9.03	8.03	7.61	6.49	6.66
\$1 under \$1M	8.72	9.98	8.66	8.03	7.42	7.52
<b>Medium Foundations</b>						
\$1,000,000 under \$10M	6.50	8.37	6.79	6.23	5.63	5.74
\$10,000,000 under \$50M	5.84	7.23	6.05	5.51	5.39	5.40
<b>Large Foundations</b>						
\$50,000,000 and up	5.91	6.62	5.34	5.32	5.00	5.08
\$100,000,000 and up		6.45	5.00	5.10	5.00	5.02

K = Thousands of dollars  
M = Millions of dollars  
<sup>1</sup>FMV = Fair market value

In light of the 1981 Act, the aggregate median payout rate changed in an interesting pattern between the years 1974-1986. The peak rate occurred in 1982. Between 1974-82 it increased from 8.4 percent in 1974 to 9.7 percent in 1982. From 1982-83 the rate declined to 8.2 percent and then, by 1986, further declined to 6.9 percent. The downward trend after 1982 indicates that after the 1981 Act, foundations began to adjust to the new law by paying out a lower percentage of assets. The total median rate then increased slightly to 7.0 percent in 1987. This occurred despite the stock market's sharp decline in October 1987.

Due, in large part, to poor market conditions and volatility, foundations earned much lower total returns on their investments in 1987. The low returns, to be

discussed later, coupled with high payout rates, led to a 1 percent decline in 1987 in real foundation fair market value of assets. The value of assets[10] declined while foundations actually increased charitable distributions, therefore an increase in the payout rate resulted. This relatively consistent pattern of foundation giving more than likely occurred, in part, due to both prior grantmaking commitments and high returns realized in 1986.

Many foundations, especially the smaller ones, give more charitable distributions than required. The smallest group, those foundations with less than \$1 million in assets, represents the only group with a payout rate greater than the total median rate for all of the years studied. This occurred, in part, since the amount of noncharitable-use assets held by small foundations tends to represent a smaller proportion of the value of total assets relative to the larger foundations. Also, small foundations receive a relatively large amount of charitable contributions and then often act as a conduit by distributing them within a year. Due to these factors and different investment and distribution goals, to be discussed later, the smaller foundations often realize higher payout rates.

Comparing the amount of charitable distributions actually given with the required amount, in 1987, 35 percent of foundations distributed more than double the required payout amount and 13 percent distributed over ten times the amount. A majority of these foundations were in the smaller size categories. The dollar amount of total distributions exceeded the required amount by 46 percent for all foundations. This number equaled an impressive 291 percent for foundations with under \$1 million in assets. These trends from 1987 are representative of foundation behavior after 1981. In spite of the 1987 market decline, more foundations met the payout requirement in 1987 than in 1986.

## INVESTMENT BEHAVIOR

### Total Rate of Return

In order to fulfill the 5 percent charitable payout requirement without an erosion of the endowment, a foundation must invest to ensure an adequate rate of

return. A comparison of the payout rate to the total rate of return will help to explain changes in the relative growth or decline of foundation assets from year to year. The total rate of return measures the total capital appreciation of the endowment of a foundation. It measures the realized income from the assets, investment and otherwise, as well as the unrealized appreciation or depreciation in value. (Two income yield measures, to be examined later, show only the realized gain or loss from investment assets.) To calculate the "total" rate of return, data files were matched from consecutive years in order to analyze beginning and ending year fair market value data. The rate measures the capital appreciation of the endowment with consideration for inflows and outflows of money. It is the same formula used by Salamon and Voytek in a study on foundation assets for the years 1979-83.[11]

Figure B shows the rates of return for the years 1983-87.[12] The data indicate that the total rate of return tends to differ from the payout rate. Although larger foundations distribute proportionately less than smaller foundations, the rate of return tends to increase as the size of the foundation increases. The larger foundations hold a greater proportion of their assets as investment securities. They seem to invest more with the goals of capital appreciation of the endowment and long-term giving. These larger organizations tend to maintain a more diversified portfolio with a greater proportion of lower income yield, higher risk, and higher growth common stock.[13] Since these holdings tend to earn higher total returns, higher rates of return for the larger foundations result. The smaller foundations seem to invest with the intention of distributing relatively large charitable contributions in the present. This group tends to hold lower risk and higher, fixed-income yield assets that do not appreciate nearly as rapidly, resulting in lower relative returns.

Foundations realized high rates of return from 1983-1986. Market conditions during these years proved very favorable to investors. As Figure B shows, in 1983 the largest foundations, those with \$100 million and more in assets, earned 11.7 percent, and in 1986, 13.9 percent. (These figures were adjusted for inflation using the GNP implicit price deflator.) Since 1984 data were not sampled, calculating rates for 1984 and 1985 was not possible. However, calculations of the two-year median figures indicate that foundations also achieved high returns during the two year span. For

FIGURE B - Rates of Return, 1983-87

SIZE OF (FMV) <sup>1</sup> ASSETS	TOTAL RATE OF RETURN (Median percentages) (1982 constant dollars)			
	1983	1984-85 (2-yr span)	1986	1987
\$1,000,000 under \$10M . . . . .	6.39	25.30	9.02	1.29
\$10,000,000 under \$25M . . . . .	9.21	31.17	11.21	-.08
\$25,000,000 under \$50M . . . . .	9.47	34.27	11.39	2.33
\$10,000,000 under \$50M . . . . .	9.21	31.31	11.38	.85
\$50,000,000 under \$100M . . . . .	9.95	38.58	11.75	1.11
\$100,000,000 and up . . . . .	11.69	29.56	13.94	1.36

M = Millions of dollars  
<sup>1</sup>FMV = Fair market value

instance, the largest group realized a median rate of 29.6 percent for the 1984-85 period. After accounting for the relatively low inflation from 1983-86, all of these size groups earned a rate of return on assets well above the 5 percent payout requirement.

The 1987 data, however, show different investment results. After inflation, foundations earned well under the minimum desired 5 percent rate of return. For instance, the largest foundations earned only 1.4 percent. This resulted, in large part, from the sharp stock market decline in October 1987. Although foundations obviously can earn positive returns after accounting for charitable distributions and inflation, fluctuations in the stock market can create negative effects as well.

During the years 1983-1986, foundations, as an aggregate, realized substantially higher returns than the rate at which they distributed charitable dollars. This contributed to the growth of aggregate foundation assets. However, in 1987, foundations with \$1 million or more in assets paid out more to charitable purposes than what they earned as total returns on investments. This led to the decline of aggregate foundation asset value from 1986-87. The changes in assets and distributions will be examined in detail later. In the future, it will prove interesting to evaluate 1988 data to ascertain whether or not foundations adjusted their payout percentages downward in response to the unusually low returns in 1987.

### Income Yield

While the total rate of return measures the change in the value of the entire endowment, the income yield

measures only the realized investment income earned by a foundation. The income yield can be calculated in two different ways: 1) "net investment income" divided by fair market value of investment assets, referred to as "NII" yield; and 2) "adjusted net income" divided by the same investment assets, referred to as "ANI" yield. [14] NII includes long-term capital gains whereas ANI does not. Figure C shows the various NII yields for different size groups for selected years

FIGURE C - Net Investment Income Yields, 1974-87

SIZE OF (FMV) ASSETS	INCOME YIELD (using Net Investment Income (NII)) (Median percentages) (1982 constant dollars)					
	1974 <sup>1</sup>	1982	1983	1985	1986	1987
TOTAL	-3.37	2.31	4.47	4.78	4.74	3.89
<b>Small Foundations</b>						
\$1 under \$100K	-3.74	2.27	3.90	4.50	3.59	3.05
\$100,000 under \$1M	-3.05	2.43	4.38	4.95	5.07	4.06
<b>Medium Foundations</b>						
\$1,000,000 under \$10M	-2.78	2.66	5.00	5.71	5.95	4.74
\$10,000,000 under \$50M	-2.27	1.52	5.48	6.00	8.25	5.99
<b>Large Foundations</b>						
\$50,000,000 and up	-2.46	1.67	5.53	6.84	7.70	5.63
\$100,000,000 and up		.58	5.06	6.56	7.08	5.53

K = Thousands of dollars  
M = Millions of dollars

<sup>1</sup>The calculation for 1974 divides net investment income by book value of assets. The use of fair market value data, unavailable for 1974, would have lowered the rates from those calculated and most likely affected the differences between the small and large foundations.

between 1982-87. Figure D shows ANI yields for 1974, 1982 and 1983.

The smaller foundations tended to earn higher ANI yields than the larger foundations, although the larger foundations earned higher NII yields for the same years. Since the NII yield includes long-term capital gains, this difference between the NII and the ANI yields supports the notions that smaller foundations hold a greater proportion of high fixed income yield assets and that the larger foundations earn the largest percentage of their NII from realized long-term capital gains.

A comparison of the NII yields with the total rates of return shows that the NII yields tended to be less than the total returns between the years 1983-86. Since the total rate of return includes unrealized gains and the NII does not, the higher total returns indicate unrealized growth in assets. However, in 1987, the year of the stock market decline and low total returns, the NII yields, although they did drop from 1986, did not drop

FIGURE D - Adjusted Net Income Yields, 1974-83

SIZE OF (FMV) ASSETS	INCOME YIELD (using Adjusted Net Income (ANI)) (Median percentages) (1982 constant dollars)		
	1974 <sup>1</sup>	1982	1983
TOTAL	-3.52	1.72	3.47
<b>Small Foundations</b>			
\$1 under \$100K	-3.91	1.92	3.29
\$100,000 under \$1M	-3.08	1.86	3.70
<b>Medium Foundations</b>			
\$1,000,000 under \$10M	-3.03	1.38	3.24
\$10,000,000 under \$50M	-2.54	.73	2.66
<b>Large Foundations</b>			
\$50,000,000 and up	-2.42	.35	2.37
\$100,000,000 and up		.09	2.21

K = Thousands of dollars  
M = Millions of dollars

<sup>1</sup>The calculation for 1974 divides net investment income by book value of assets. The use of fair market value data, unavailable for 1974, would have lowered the rates from those calculated and most likely affected the differences between the small and large foundations.

Note: This yield was not calculated for the years 1985, '86, and '87 since the necessary 990-PF 1/e items in the years following 1983 were not added.

nearly as much as total returns. In fact, they exceeded the total returns for that year. This shows the unrealized loss that occurred in 1987.

## CHARITABLE DISTRIBUTION AND ASSET GROWTH, 1982-87

The percentage increases between 1982-87 of aggregate assets and charitable distributions, 56 percent and 38 percent, respectively, equaled \$31.7 billion in assets and \$1.7 billion in distributions. Did the changes in foundation investment and payout practices since the 1981 Economic Recovery Act lead to the increases in the value of assets and charitable distributions? The relatively low inflation and interest rates in the 1983-87 period and a market that yielded relatively high returns through 1986 no doubt helped to impact the growth of foundation assets. However, relatively high foundation growth as compared to growth in the GNP, the effects of the change in the payout requirement, discussed previously, and differences in the growth rates of different sizes of foundations would all indicate that the 1981 Economic Recovery Act also has impacted the growth of foundation assets and distributions.

### Fair Market Value of Assets

From 1979-1986, total foundation assets tended to grow mostly at an increasing rate. Assets grew 65

percent over the eight year period.[15] The majority of the growth occurred from 1982 to 1986. Assets then declined by 1 percent from 1986-87. Figure E shows dollar amounts and percentage changes in assets for all size groups between 1979-87. Since 1981, all of the size groups have grown considerably in asset size and in number.

Assets tend to increase at a faster rate with increases in the size of the foundation. Since the larger foundations tend to earn relatively high total rates of return and pay out relatively low percentages of assets, not surprisingly, the larger foundations increased assets at a faster rate than did the smaller ones. From 1982-87 those

foundations holding \$100 million and more in assets increased by 85 percent in assets, the largest increase of all of the size groups. The smallest foundations, those under \$1 million, increased by 29 percent in assets during the same years.[16]

### Charitable Distributions

Aggregate charitable distributions also have grown considerably since the 1981 Act. Figure F displays the changes in distributions from 1974-87 for each size group. The totals show that qualifying distributions grew steadily by 45 percent from 1979-87, after showing a 5 percent decline from 1974-79.

FIGURE E - Fair Market Value (FMV) of Private Foundation Assets, 1979-87

SIZE OF (FMV) ASSETS	FAIR MARKET VALUE OF ASSETS <sup>1</sup> (Amounts and percent changes)					
	1979	1982	1983	1985	1986	1987
TOTAL: (Amount) (Percent change from prior year listed)	53,994,833	56,203,718 + 4.1	61,143,424 + 8.8	78,003,388 +27.6	88,841,283 +13.9	87,897,872 -1.1
\$1 under \$100K	476,081	330,972 -30.5	336,365 +1.6	359,321 +6.8	359,180 -.0	355,635 -1.0
\$100,000 under \$1M	3,699,261	3,071,767 -17.0	3,396,108 +10.6	3,375,908 -.6	3,814,486 +13.0	4,027,976 +5.6
\$1 under \$1M	4,175,342	3,402,739 -18.5	3,732,473 +9.7	3,735,229 +.1	4,173,666 +11.7	4,383,611 +5.0
\$1,000,000 under \$10M	11,097,800	10,527,069 -5.1	11,718,911 +11.3	12,422,991 +6.0	14,424,320 +16.1	13,560,055 -6.0
\$10,000,000 under \$50M	11,727,444	12,156,788 +3.7	12,651,431 +4.1	15,175,491 +20.0	15,956,840 +5.1	15,944,998 -.1
\$50,000,000 and up	26,994,247	30,117,121 +11.6	33,040,609 +9.7	46,669,677 +41.2	54,286,456 +16.3	54,009,209 -.5
\$100,000,000 and up	-	24,779,239	27,733,991 +11.9	38,611,884 +39.2	45,828,676 +18.7	45,857,255 +.1

Note: See footnotes at the end of Table F, below.

FIGURE F - Private Foundation Qualifying Distributions, 1974-87

SIZE OF (FMV) ASSETS	QUALIFYING DISTRIBUTIONS <sup>1</sup> (Amounts and percent changes)						
	1974	1979 <sup>2</sup>	1982	1983	1985	1986	1987
TOTAL: (Amount) <sup>3</sup> (Percent change from prior year listed)	4,316,233	4,113,587 - 4.7	4,553,587 +10.7	4,653,226 +2.2	5,170,329 +11.1	5,945,893 +15.0	6,262,171 +5.3
\$1 under \$100K	263,543	227,687 -13.6	96,379 -57.7	275,726 +186.1	141,151 -48.8	329,234 +133.2	201,641 -38.8
\$100,000 under \$1M	605,130	539,840 -10.8	455,690 -15.6	525,426 +15.3	507,821 -3.4	463,713 -8.7	601,819 +29.8
\$1 under \$1M	868,673	767,527 -11.6	552,069 -28.1	801,152 +45.1	648,972 -19.0	792,947 +22.2	803,460 +1.3
\$1,000,000 under \$10M	970,785	1,117,038 +15.1	1,204,782 + 7.9	1,151,232 -4.5	1,017,732 -11.6	1,213,634 +19.2	1,290,379 + 6.3
\$10,000,000 under \$50M	627,389	1,009,852 +61.0	998,153 -1.2	972,526 -2.6	1,068,060 +9.8	1,193,878 +11.8	1,256,847 +5.3
\$50,000,000 and up	1,714,169	1,450,856 -15.4	1,792,087 +23.5	1,727,731 -3.6	2,331,142 +34.9	2,630,215 +12.8	2,875,835 +9.3
\$100,000,000 and up	-	-	1,334,123	1,344,882 +.8	1,787,323 +32.9	2,125,602 +18.9	2,382,142 +12.1

K = Thousands of dollars

M = Millions of dollars

(<sup>1</sup>) a) Dollar amounts are in thousands (000s).

b) Dollar amounts are constant 1982 dollars obtained by using the implicit price deflator.

(<sup>2</sup>) The 1979 total represents the true total for nonoperating foundations. However, the amounts for each of the sub-totals in 1979 represents the amount for all foundations (nonoperating and operating). This is due to limitations in the 1979 data.

(<sup>3</sup>) The sum of the sub-totals does not equal the listed total for each year since this table does not reflect the sub-group, "Assets Zero or Unreported."



For the period after the 1981 Act, the smallest group, (under \$1 million in assets), not surprisingly, is the only one that paid out qualifying distributions at a faster rate than the growth in their assets. This group experienced larger percentage increases in charitable distributions from 1982-87 than all of the other groups, with the exception of the largest. The group realized a 46 percent increase in distributions from 1982-1987. This compares to its 29 percent gain in assets during that time. However, for foundations with assets equal to or greater than \$1 million, assets increased at a faster rate than distributions from 1982-87. The largest group (\$100 million and more in assets) realized a 79 percent increase in distributions, also a sizeable improvement over its charitable giving before the 1981 Act. This compares to its 85 percent growth in assets.

These trends differ markedly from those between the years 1979-82. Percent changes between these years indicate that the largest foundations had distributions that increased faster than assets and that the smallest foundations had assets that decreased by less than distributions. However, from 1982-87 these trends changed and all foundations were able to increase both assets and distributions. It seems that the 1981 Act allowed foundations to increase distributions while simultaneously increasing their endowments. Interestingly, from 1982-87, the largest foundations, although they had the lowest payout rates, due to significant capital appreciation, also realized the largest increases in qualifying distributions.

#### Effects of a Market Decline, 1987

When isolated, the 1986-87 data indicate different results from the entire 1982-87 period. Even after achieving poor investment results in 1987, all of the size groups, except the smallest, paid out qualifying distributions at a faster rate than the change in the value of assets. However, during this time the smallest foundations actually increased assets more than distributions. These reverse patterns help to show the effect of the 1987 "crash" on the behavior of foundations. The patterns also emphasize the capability of the larger foundations to better withstand market swings and to increase long-run distributions and assets at the greatest rate. Figures E and F best emphasize the changes. In addition, Figure G shows changes in assets and distributions using constant dollar stratification, rather than current dollar stratification.[17]

**FIGURE G - Changes in Assets & Distributions, 1982-87  
Using Constant Dollar Stratification**

SIZE OF (FMV) ASSETS (Stratified by 1982 constant dollars)	1982-87: Percentage Changes <sup>1</sup>					
	1982-87		1982-86		1986-87	
	(FMVA)	(ChDist)	(FMVA)	(ChDist)	(FMVA)	(ChDist)
Total	56.4	37.5	58.1	30.6	-1.1	5.3
\$1 under \$1M	48.6	59.6	36.2	50.6	9.1	6.0
\$1,000,000 under \$10M	35.4	11.1	41.3	3.9	-4.1	6.9
\$10,000,000 under \$50M	35.5	25.1	34.5	17.7	.8	6.3
\$50,000,000 under \$100M	55.0	31.7	55.7	27.3	-.4	3.5
\$100,000,000 and up	76.9	61.5	80.3	49.2	-1.9	8.3

M = Millions of dollars  
 FMVA = Fair market value of assets  
 ChDist = Charitable "qualifying" distributions  
<sup>1</sup>Dollar amounts are constant 1982 dollars obtained by using the implicit price deflator.  
 Note: See footnote [17] for a detailed explanation of these changes.

### FOUNDATION DECISION-MAKING

The primary purpose of a private foundation in society is one of charitable distribution. Increasing the long-run amount of foundation charitable distributions represented one of the original goals of the Economic Recovery Act of 1981. The results following this change in the payout requirement indicate a successful aftermath to the legislation, and an attainment, at least in part, of the goal. Foundation long-term charitable distributions did increase after accounting for inflation. In a very favorable market environment between 1983-86, foundations realized total rates of return that easily allowed them to both meet the payout requirement and increase the value of their assets. In response to the 1981 Act the largest foundations seemed to adjust their payout rates downward and re-invest more. However, from 1982-87 they increased charitable distributions at the fastest rate despite relatively low payout rates. Their endowments appreciated rapidly in value due to large unrealized gains, leading to higher required payout amounts, and then, increased long-run distributions. The long-run growth in assets allowed these foundations to increase distributions at the fastest rate. The smallest foundations, after 1981, did not notably re-adjust their payout rates downward, although they did increase both assets and distributions. In fact, they increased distributions faster than assets from 1982-87.

Obviously, different foundations assume different roles and behave accordingly. The disparity between 1987 and the other years studied may shed light on the nature of the decision-making processes of foundations. The question arises: does the rate of return (and

possibly the NII yield) in one year affect the payout rate of that same year and/or the next year? In other words, do certain foundations respond to low returns with low payout rates or to high returns with high payout rates? And, do these patterns differ with the size of the foundation?

It appears that the investment returns of smaller foundations determine, at least in part, the amount of charitable dollars distributed in the same or, more likely, in the next year. For instance, the smallest foundations may have responded to relatively low income yields (NII and ANI) in 1982 by paying out distributions at lower rates in 1983. Similarly, their percentage increase in distributions may have slowed in 1987 due to hesitancy after realizing lower NII yields in that same year. The smaller foundations, who earn a relatively large proportion of total revenue as contributions, also rely, in part, on these contributions to help fund charitable giving. The decline in contributions received in 1987 may also have affected charitable giving in that year. These foundations tend to distribute proportionately large amounts in the present, based, in part, on contributions, investment returns, and income yields.

Conversely, the goal of a more pre-determined payout policy appears to drive the operations and investment policies of the larger foundations. They better manage their investments and distribute dollars in such a way as to promote long-run growth of the endowment. A growing endowment will fund charitable grants at the same or at an increased value in the future. These foundations tend to distribute charitable dollars at relatively consistent payout rates irrespective of changing rates of return. For example, the larger foundations continued to pay out an increased amount in 1987 despite low rates of return and declining assets in that year. These foundations tend to operate with a more planned and structured payout policy.

A future examination of payout practices in 1988 after the unusually low investment returns of 1987 will provide additional insight into the investment and distribution goals and behavior of the different sizes of foundations. The different methods of foundation distributing and investing provide important philanthropic resources and initiatives for the present and the future.

In light of the large social welfare budget cuts of the last decade, private philanthropic sources have become an increasingly important source of social funding in the United States. These data can help to better assess the long-run effects of policy on the investment and payout behavior of foundations in order that policy would be continually shaped to help achieve maximum benefits for society while simultaneously considering the interests and growth of foundations.

## DATA SOURCES

The data used in these analyses originated from the stratified samples selected in the years 1974, 1979, 1982, 1983, 1985, 1986, and 1987. For complete descriptions of statistical procedures and data sources and limitations, please refer to the corresponding *Statistics of Income (SOI) Bulletin* articles for each of the years studied. These can be found in the recently published *Compendium of Studies of Tax-Exempt Organizations, 1974-87*. [18]

In order to obtain rates of return for the years 1983-87, data files from consecutive years were matched using the identifying numbers (EINs) of the organizations in the sample. The rate of matching the organizations varied from an average of 61 percent for those organizations in the \$1 million under \$10 million size category to an average of 97 percent for those in the \$100 million and over category. The total average matching rate for all of the years studied equaled 73 percent. Weights were applied on each record matched by using the higher of the two weights from the years used in the match.

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ing of the paper and designed graphics for the presentation; and Peggy Riley, Tom Petska, Jim Hobbs, and Dan Skelly, who all reviewed the paper and provided helpful comments.

## NOTES AND REFERENCES

- [1] Nonoperating foundations primarily distribute grants to individuals and other nonprofit groups, whereas operating foundations devote a required percentage of income to the operation of their own charitable programs and services. Since tax law requires that only nonoperating foundations fulfill a charitable distribution requirement, the analyses in this paper will focus only on the nonoperating type.
- [2] All references to assets are stated at their fair market value unless otherwise indicated.
- [3] The GNP implicit price deflator was used in all applicable instances. Please refer to the *Economic Report of the President*, U.S. Government Printing Office, Washington, DC, February 1990, Table C-3. Unless otherwise indicated, the stratification of the sub-groups by asset size is not adjusted for inflation. This preserves size classification by current dollars.
- [4] Hopkins, Bruce R., *The Law of Tax-Exempt Organizations*, 5th ed., 1987, p.17.
- [5] See Reilly, Raymond and Skadden, Donald H., *Private Foundations: The Payout Requirement and its Effect on Investment and Spending Policies*, University of Michigan Graduate School of Business Administration, 1981.
- [6] The asset figure used to calculate the payout amount is the monthly average of the fair market value of those assets not used for charitable purposes minus adjustments for acquisition indebtedness and cash held for charitable activities. The fixed percentage now is 5 percent, but at the time of the 1969 Act it was 6 percent or, in some instances, 5.5 percent.
- [7] Salamon, Lester M. and Voytek, Kenneth P., *Managing Foundation Assets: An Analysis of Foundation Investment and Payout Procedures and Performance*, The Council on Foundations, 1989.
- [8] The calculated rates (all types) and amounts found in this paper for specific years include foundations having accounting periods that can include either all of that particular year or part of that year and part of the following year. For instance, a 1987 return could represent an accounting period that includes January 1987 through December 1987 (most likely) or even one that includes December 1987 through November 1988.
- [9] The payout formula adjusts qualifying distributions with slight additions and subtractions that are made to the required "distributable amount" on the Form 990-PF. It also adjusts for excess distributions given in the past and applied to the requirement of the current filing year.
- [10] The volatile stock market no doubt affected the asset value of a foundation differently depending on its accounting period. For instance, since the payout rate depends on a monthly average of assets, those foundations following a calendar year schedule realized nine relatively solid months prior to October's decline or "crash." The payout rate calculation, then, would account for both the positive and negative months.
- [11] Salamon and Voytek, *Ibid.*
- [12] Due to the rates of matching specific returns in the sample by the identifying number (EIN), the rate of return could only be calculated for those foundations with \$1 million and more in assets. The matching rate for the smaller foundations was too low to ensure a proper level of statistical confidence.
- [13] Salamon and Voytek, *Ibid.*
- [14] The ANI yield can only be calculated for 1974, 1982 and 1983, since the adjusted net income line item was not edited in years after 1983. The amount will be collected beginning in 1990.
- [15] 1979 is the first year sampled that includes fair market value figures.

[16] These increases in asset size are biased slightly upward for the largest group and slightly downward for the smallest group due to the stratification of assets based on current dollars. Some foundations moved to a higher size-group from year-to-year due to inflationary increases in assets.

[17] After tabulating the data by stratifying the size-groups using 1982 constant dollar assets, the data show similar results. Using this method, over the period 1982-87, the largest foundations increased by less in number, assets, and distributions than when using current dollar stratification. The smallest foundations increased by more in number, assets, and distributions, thus narrowing the difference between the two groups. However, the largest foundations still performed better than the smallest in all three areas. Figure G highlights these changes.

Using this method, the breakdown of the period 1982-87 into the years 1982-86 and 1986-87 proves interesting. Similar results occurred with one exception. Using this method, from 1982-86, the smallest foundations actually realized the greatest increase in qualifying distributions, with a 51 percent gain, as compared to a 49 percent gain for the largest foundations. However, the largest group achieved the largest gain in distributions over the entire 1982-87 period. This also emphasizes the capability of the larger foundations to better withstand market swings and to increase long-run assets and distributions at the greatest rate.

[18] *Compendium of Studies of Tax-Exempt Organizations 1974-87*, Dept. of Treasury, IRS, Statistics of Income Division, Publication 1416, Catalog #10313C, 1990.