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New Act Simplifies Excise Tax on Investment Income for Private Foundations

January 27, 2020

Client Advisory

January 27, 2020 by Ahsaki E. Benion, Pamela A. Mann and Jeremy S. Steckel

On December 20, 2019, the *Taxpayer Certainty and Disaster Tax Relief Act of 2019* (the "Act") was signed into law. The Act makes an important change to the excise tax on private foundation investment income, a change for which the private foundation sector has long advocated.

Prior to the Act, under Internal Revenue Code ("Code") § 4940(a), a private foundation exempt from tax under Code § 501(a) was subject to an annual excise tax equal to 2% of the foundation's "net investment income," which generally consists of interest, dividends, rents, royalties, and capital gain income minus expenses incurred to earn such income. Under prior Code § 4940(e), the excise tax rate would be reduced to 1% if the foundation's "qualifying distributions"—i.e., grants and other amounts paid to accomplish its charitable purposes—for the taxable year were equal to or greater than an amount equal to

(i) the foundation's assets during the taxable year multiplied by the average percentage of its assets paid out as qualifying distributions over the five previous taxable years (the "base period"), plus

(ii) 1% of the foundation's net investment income for the taxable year.

Note that a foundation was not eligible to receive the reduced investment income excise tax rate if it was liable for tax under Code § 4942 (which imposes a steep excise tax on any private foundation that fails to meet minimum qualifying distribution requirements) during any year in the base period.

Essentially, prior to the Act, a private foundation would qualify for the reduced excise tax rate if its percentage of qualifying distributions made during the taxable year exceeded its percentage of qualifying distributions over the previous 5 years by an amount greater than the 1% excise tax savings. This created a short-term incentive for foundations to increase qualifying distributions each year in order to qualify for the lower 1% excise tax rate, but it also had unintended consequences. The two-tiered tax structure incentivized foundations to refrain from making unusually large payouts in any one year because a spike in the percentage of annual giving relative to assets would raise a foundation's average level of distributions, making it more difficult to qualify for the reduced excise tax rate over the succeeding five years. The two-tiered system also created an administrative burden, requiring foundations to carefully manage and monitor their grant making to minimize the excise tax consequences. Both large and small private foundations have long advocated for a simplified, flat excise tax rate to ease the burden of compliance.

The Act amends the Code to reduce the § 4940(a) excise tax rate from 2% to 1.39% and to delete § 4940(e) in its entirety. Now, a private foundation's excise tax on net investment income no longer depends on the percentage of assets paid as qualifying distributions year-to-year; all tax-exempt private foundations must pay a single, flat tax of 1.39% on net investment income each year, regardless of qualifying distributions made. According to the Senate Committee on Appropriations, the simplified tax structure is intended to encourage private foundations to make larger one-time donations, such as is needed in the case of disaster relief.

The relevant provision of the Act (which was enacted as part of the larger *Further Consolidated Appropriations Act*, *2020*) are effective for all taxable years beginning after December 20, 2019. For foundations on the calendar year, this means the Act is effective for the year beginning January 1, 2020. Note that the Act does not impact the minimum distribution provisions of Code § 4942, which generally require that, in each taxable year, a foundation must make charitable expenditures in an aggregate amount equal to at least 5% of the fair market value of its assets (other than those assets used directly in carrying out its exempt purposes).

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