

"Recommendations for Reform of the United States Philanthropic Sector"

*A Statement to the United States Senate Committee on Finance
By the National Committee for Responsive Philanthropy*

June 22, 2004

The National Committee for Responsive Philanthropy (NCRP) has long advocated for significantly improving philanthropic accountability and responsiveness and the means for providing necessary oversight and enforcement. It is insufficient to call for stronger oversight and enforcement of the standards of philanthropic accountability if the standards are inadequate or completely missing. This statement outlines the elements of philanthropic accountability that should be the basis for both public policy and foundation self-regulation to create a truly responsive and accountable philanthropic sector.

For more than a year now, the media have regularly uncovered and reported on egregious instances of abuse and mismanagement in the nation's private foundations. Most of the nonprofit and philanthropic sectors' leaders have dismissed nearly every case of felonious behavior as an exception to the rule, the bad apple ruining the otherwise pristine collective barrel of American philanthropy. This defense was excusable in perhaps the first, second, and third cases of abuse that were uncovered. But as more examples of astoundingly illegal and unethical behavior are revealed, this line of defense sounds both hollow and cowardly.

It is not enough to offer vague calls for better accountability within and public oversight over the philanthropic sector as other leaders have done. It is time to be specific. It is time to recommend comprehensive reforms to bring about new standards of public and private accountability to the 65,000 private foundations that control \$500 billion in philanthropic assets in the United States today. Independent research, by the way, estimates that at least 45 percent of those \$500 billion belong to the American public, having been

accumulated thanks to various tax breaks that foundations receive at their inception and throughout their institutional lives.¹

Speaking of the American people, public trust in the nation's charities and foundations is at historically low levels. They have read the news stories about scandals in philanthropy, and they have concluded what most of the media and many lawmakers—but only a few leaders of philanthropy—have concluded as well: It's time for change. The current laws and regulations pertaining to foundations were established more than 30 years ago, when the philanthropic sector was much smaller, both in numbers and dollars. In the last ten years alone, the number of foundations has doubled and their assets have more than tripled.

The U.S. Congress has a responsibility and obligation to pass new and better laws to regulate private philanthropy. Because foundations wield so much financial power and influence over their grantee organizations—which know foundations the best, the calls for reform will not be coming from the nonprofit sector. And the public has no say in who sits on foundation boards of directors, so there are no outside share- or stakeholders to bring foundations into line. The government, therefore, must step in and take action. No other entity has the authority, integrity, or courage to do so.

This statement will provide concrete suggestions for reform of the nation's philanthropic sector. Foundation leaders will be unhappy with many of them, but this statement was crafted not to please the philanthropic elite, but to bring a sense of democratic and fair governance and oversight to billions of dollars that are not living up to their legal mandates or ethical obligations.

The suggestions are organized into three broad areas:

¹ Mark Dowie. *American Foundations: An Investigative History*. Cambridge: MIT Press, 2002.

- Maximizing foundation accountability and transparency
- Maximizing foundation support for nonprofits
- Maximizing foundation support for justice and democracy

These suggestions were drafted based on my organization's observation of and research on current deficiencies among the nation's foundations, as well as comments from our organizational members and board of directors.

It is an honor and privilege to offer this statement to the United States Senate Committee on Finance. I sincerely hope that they are helpful in the Committee's initial efforts to bring about a new era of reform and transparency for the United States philanthropic sector.

Maximizing Foundation Accountability and Transparency

- Use the foundation excise tax: Reduce and consolidate the private foundation investment excise tax to 1% of investment income and devote the bulk of the tax payment to IRS and state government oversight of nonprofits and foundations—as the foundation excise tax was originally intended to be used when first enacted. The remainder can and should be used to supplement government oversight through grants for nonprofit activities such as research and data collection on the nonprofit sector, nonprofit accountability standard setting, and special investigations.

In January 2004, NCRP reaffirmed its support for simplifying and reducing the tax from a complex variable rate that wavers between 1 percent and 2 percent, to a consistent 1 percent rate of private foundation investment income. The reduction in the excise tax will

free up potentially more than \$140 million for foundation grantmaking. But \$350 million or more will remain in general revenues, and it should be used to address its originally intended purpose—the public oversight costs for philanthropic accountability.

NCRP's legislative proposal for making the foundation excise tax a tool for a more accountable philanthropic sector includes the following:

1. Reduce the foundation tax to a simplified, consolidated 1 percent of private foundation investment income, but require that the money that foundations "save" from the tax reduction go to nonprofit organizations in the form of grants—as opposed to being used by foundations to increase foundation executives' salaries, foundation trustees' compensation, and other expenses.
2. Dedicate 20 percent of the remaining excise tax to more than double the budget of the Tax Exempt/Government Entities division of the Internal Revenue Service from its current budget of less than \$60 million to approximately \$130 million, enabling it to more effectively oversee and audit private foundations, public grantmaking foundations, donor advised funds, and other philanthropic grantmaking mechanisms, as well as nonprofits in general, to weed out the more than a few bad apples currently undermining the accountability of philanthropy and charity.
3. Dedicate 40 percent of the remaining excise tax to create a fund of \$140 million, which the Commissioner of the Internal Revenue Service (IRS) can use to supplement the charity investigative and oversight arms of state attorneys-general offices.

4. Allocate 15 percent (or approximately \$50 million) of the remaining excise tax for the IRS Commissioner to grant to nonprofit organizations whose research, ratings, and evaluation efforts complement and augment the oversight functions of federal and state agencies.
5. Use another 15 percent of the excise tax for the generation of IRS statistics on the finances of foundations and charities comparable with the research IRS generates on other sectors of the economy.
6. Reserve the remainder of the excise tax revenues to support special initiatives of the Tax Exempt/Governmental Enterprises division of IRS and for additional research and data collection and dissemination.

The private foundation excise tax, originally set at 4 percent of foundation investment income when enacted in 1969, was intended to pay for IRS costs of overseeing tax-exempt organizations. Had the reduction of the foundation excise tax been enacted to start in 2004, \$144 million would have been potentially freed up for grantmaking in the first year and nearly \$200 million in the second year.

Oversight and enforcement of the nonprofit sector has changed since 1969, when Congress last implemented broad changes to rules pertaining to nonprofits and foundations. The responsibility is no longer just that of the Internal Revenue Service's Tax Exempt Division, but also the charity oversight offices of states attorneys-general, few of which were on the radar screen 35 years ago; their on-the-ground roles in monitoring foundations and nonprofits overall should be supported by the excise tax whose primary purpose was meant to bolster foundation and nonprofit accountability.

Bolstering philanthropic oversight is crucial, given the explosive growth in the number of private foundations, plus other kinds of grantmaking charities, while IRS audits of foundations plunged from 1,200 in 1990 to less than 200 in 1999 and considerably less today.

- Improve IRS forms 990PF and 990: The 990 needs to be radically overhauled to reveal important information about foundations (and public charities) for necessary review and oversight; foundations and nonprofits should be able to e-file; and there should be significant penalties for foundations that do not file their 990PFs on a timely basis. All publicly disclosed data should be available in a free, publicly accessible and searchable format.

Some of the recommendations below—such as disclosure of insider relationships between foundations and outside vendors providing services for hire—can be implemented through changes to the IRS Forms 990PF and 990. Institutions filing these forms should also be regularly required to state *in specific terms* how their grantmaking and/or programmatic activities further their tax-exempt purposes.

- Increase disclosure of corporate philanthropy: The bulk of corporate giving to nonprofits, whether above- or below-the-line, is not disclosed to the public due to the privacy of corporate tax returns and the unwillingness of the SEC to demand disclosure. The recent trajectory of corporate abuses including philanthropic misbehavior makes the need for enhanced disclosure clear.

Corporations undoubtedly have a variety of motives for giving to charity. Tax breaks, positive publicity, and a genuine concern for the public good could all encourage a company to donate its money, time, products, or services to charity. In more sinister cases, corporate charitable gifts could also be used as bribes to encourage

corporate directors to overlook financial improprieties, as in the case of Enron.

Corporations receive significant tax breaks for their giving—the money that they donate is in a sense “public,” since it is actually lost tax revenue for the government and the general public. Further, whether or not it is a motivation for giving, being seen as a good corporate citizen undoubtedly helps a company’s bottom-line. For example, in 1999 Philip Morris spent \$75 million on charitable contributions, and \$100 million to publicize these donations.² Corporate philanthropy, then, can be viewed in many cases as government subsidized advertising for for-profit corporations. Further, there is evidence that corporate philanthropy is being used to perpetrate and perpetuate scandals in corporate America—to the eventual detriment of shareholders, nonprofits, and citizens alike.

For these reasons, NCRP recommends that the SEC adopt disclosure requirements

for all corporate philanthropic donations—in-kind or cash, through a foundation or directly from the corporation. The amount donated, as well as the recipient of the funds, needs to be made public through paper and electronic means on an annual basis. Such a policy would help restore some faith in corporate America, as well as the recipients of its charity. It would also allow researchers and advocates to understand a significant piece of US private giving and work to make it more fair and responsive to the country’s neediest and most disadvantaged citizens.

- Disclose grantmaking by public charities: Private foundations are not the only charitable grantmakers. While some public charities such as community foundations routinely and completely disclose

² Michael E. Porter and Mark R. Kramer. “The Competitive Advantage of Corporate Philanthropy.” *Harvard Business Review*, 2002.

their grantmaking, the grantmaking disclosure performance of public charities overall is spotty. The public deserves to know who receives how much of charitable grantmaking whether from public or private charities.

Current IRS regulations for both public charities and private foundations require the public disclosure—on IRS Form 990 or 990-PF—of grantees (including the organization's name and full contact information), specific purposes of grants made, and potential conflicts of interest. Based on our use of literally thousands of these documents for various research projects, only one foundation comes to mind that follows these requirements. More often than not, the only information offered is the name of the grantee organization and the grant amount. Contact information, a specific (or even general) description of how the money will be used, and conflict of interest information are rarely, if ever, provided.

- Disclose the grantmaking from donor-advised funds: Donor-advised funds (DAFs) are increasing rapidly, but there is virtually no disclosure of their grantmaking, much less oversight of their philanthropic probity. At a minimum, a comprehensive regime of DAF disclosure should be established.

In 2003 alone, nearly 70,000 new DAFs were established, according to the *Chronicle of Philanthropy*.³ A private financial adviser has set up a website (www.donoradvisedfunds.com) to educate potential clients why they should set up DAFs instead of private foundations. According to this website: "Starting a private foundation can involve substantial start up costs and administrative expenses, such as the yearly filling of a Form 990-PF. But one of the most important differences is that Donor Advised Funds receive more

³ Leah Kerkman and Nicole Lewis. "Donor Funds Are on the Rise Again." *The Chronicle of Philanthropy*, May 27, 2004.

favorable tax treatment than a private foundation. Donor Advised Funds allow donors to take a federal income tax deduction up to 50% of adjusted gross income (AGI) for cash contributions and up to 30% of adjusted gross income (AGI) for appreciated securities; versus 30% of AGI for cash contributions and 20% of AGI for appreciated securities for a private foundation. Donor Advised Funds also offer the ability to recommend grants anonymously, if desired."

Another perk, this site points out, is that donors receive all of these tax breaks, but do not have to make grants to any charitable organizations anytime soon—while the funds continue to grow. But it is recommended, however, that a DAF make a minimum grant contribution of \$250 annually.

If donors want to continue to receive significant tax breaks for "giving" through DAFs, then they must be held accountable in radically new ways. At a minimum, DAFs should have the same disclosure requirements that public charities and private foundations have, and they should be required to pay out at least 6 percent of their financial holdings annually to charities.

- Disclosure of all insider relationships with foundation vendors: Foundations only list a small number of their outside vendors providing accounting, investment, consulting, and other services, without any obligation to identify which are related to foundation trustees or officers. Disclosure of vendors should include all firms with business relationships with foundation insiders, piercing the "doing business as" shield some insider vendors currently hide behind.

Stronger definitions of and restrictions against foundation trustee self-dealing also should be implemented, especially a standard that eliminates the practice of investing foundation assets through

foundation trustees' firms or funds. The Bielfeldt Foundation, in Peoria, Illinois, paid nearly \$3 million to three members of the Bielfeldt family for investment services. The foundation's assets were invested in risky futures trading, resulting in a 64 percent loss in value in just two years. These types of services should be outsourced on a competitive basis to companies that are qualified to invest what are largely public dollars.

- Foundation CEO and staff salaries: NCRP continues to advocate that foundation salaries and other foundation administrative expenses should be removed from calculations of qualifying distributions (payout). Removing administrative costs from foundation payout—while maintaining or increasing the required foundation payout rate—will result in more grant dollars going to nonprofits and provide funders with incentive to be more efficient when spending money on themselves as opposed to their grantees. NCRP does not advocate that there should be specific limits or caps on the salaries of foundation executive directors or staff, but that foundation trustees should review executives' salaries very carefully and include in their calculations pensions, stock options, and other perks. In addition, foundations should disclose the total compensation paid—including benefits, severance packages, and other payments—to senior staff members.

According to NCRP analyses of IRS data on private foundations, in 2000 \$2.5 billion in foundation administrative expenses were included in their payout calculations. On average, throughout the 1990s, each year nearly half of these payout-related administrative expenses—44 percent—was used for foundation executive, board of trustee, and staff salaries and related benefits. As a matter of principle, foundations should not be allowed to count a \$1 million severance package to an outgoing CEO as the legal and financial equivalent of a \$1 million grant to a nonprofit organization.

Foundations receive tax breaks in exchange for their charitable purpose, which is to get their assets into the hands of nonprofit organizations. The constitution of foundation payout should reflect this legal reality.

- Limiting foundation trustees' compensation: In nearly all cases, foundation trustees should not be compensated for their board service. If trustee compensation is deemed necessary, NCRP calls for limiting compensation or fees for foundation trustees (not including reimbursement for reasonable travel and incidental expenses) to no more than \$8,000 per year from *all* sources (i.e., not only fees, but also compensation through contracts for services such as legal, accounting, and investment functions). Like salaries and other administrative costs, foundation trustee fees should be removed from foundations' qualifying distributions.

If a public charity paid its board members, most foundations would probably not even consider it for a grant. Ideally, all board service in the nonprofit sector should be thought of as volunteer work, not as a highly paid part-time job. And many board positions are highly paid. A recent study from the Center for Effective Philanthropy, for example, found that the median hourly compensation rate of foundation board trustees in its research sample was \$324.⁴

Ideally these rates should be reduced to a maximum of \$8,000 per trustee per year, and such payments should not count toward a foundation's annual grants payout.

- Foundation diversity: Despite some progress, the diversity of the philanthropic sector still needs improvement. Racial, ethnic, gender, and class diversity should be addressed and increased, particularly among private foundation board members who are still

⁴ The Center for Effective Philanthropy. *Effective Governance: The CEO Viewpoint*. 2004.

overwhelmingly white, male, and upper class. Information on the diversity of foundation board members, senior staff members, professional staff, and other staff should be publicly disclosed.

A semi-regular survey from the Council on Foundations tracks the racial and gender diversity of foundation board members. In 1982, 77 percent of all foundation board members in the survey were men. In 2000, some erosion of the gender divide occurred, but not much, with men representing 66 percent of all foundation board members. Similarly, in 1982, 96 percent of all board members in the survey were white, which fell to 90 percent in 2000.

Because foundations are using largely public dollars and many claim to serve minority and other disenfranchised populations, it makes sense that foundation staff and board members should reflect the citizens of the United States—or, at the very least, the communities the foundations strive to serve—in racial, gender, ethnic, and class terms.

Maximizing Foundation Support for Nonprofits

- Emphasize core operating support grantmaking: NCRP maintains that at least half of foundation grant dollars should be in the form of core operating support or flexible grants as opposed to restrictive, program- or project-specific grants. NCRP's research indicates that giving nonprofits flexible, unrestricted grant support leads to stronger organizations, better support for the communities they serve, and improved relationships between grantors and grantees. Unlike foundations, nonprofits cannot simply give themselves grants to cover their core administrative costs. Additionally, in program or project support, the full cost of nonprofits' reasonable related

administrative or "indirect" expenditures should be included in the foundations' grants.

According to the Foundation Center, in 2002 only 12 percent of the grant dollars given away by the 100 largest foundations—based on total giving—were for general/operating support. The next largest 900 foundations gave nearly 22 percent of their grants dollars through general/operating grants.⁵ Time-series data from the Foundation Center show that most foundations in the past two decades have shifted more of their grantmaking dollars into project specific grants, away from general/operating support grants. The nonprofits we work with tell us on a regular basis that they are struggling to serve and represent their constituencies, in part due to the financial pressures and restrictions that this shift in foundation grantmaking has produced.

- Increase foundation grants payout: NCRP reaffirms its longstanding position that private foundation spending, or payout, should be a minimum of 6 percent annually, with all administrative and operating expenses excluded from the payout and qualifying distributions calculations.

Right now, private foundations are required to pay out 5 percent of their assets each year. Again, this 5 percent currently includes foundation overhead expenses, as well as grants to nonprofit organizations and program related investments. Many foundations pay out exactly 5 percent each year, effectively turning the 5 percent floor into a 5 percent ceiling. IRS data show that smaller foundations tend to exceed the 5 percent minimum much more frequently than larger foundations; smaller foundations also tend to have little—and in some cases, no—overhead costs.

⁵ The Foundation Center. *Foundation Giving Trends*, 2004.

Interestingly, the foundations with the most overhead costs tend to also have the lowest payout rates, even when taking overhead costs into consideration. For example, the IRS analyzed the payout rates of the 50 largest foundations from 1985-1997, and found that only thirteen actually met or exceeded 5 percent. The other 37 foundations fall short of this legal requirement, sometimes by more than one full percentage point. Looking at the ratio of grants to assets, only four of these top 50 foundations met or exceeded 5 percent in 1997.

Many foundation leaders oppose increasing the foundation payout rate because they claim that any rate about the current 5 percent increases their minimum spending requirement to a level that is not sustainable, effectively drawing down foundation assets to nothing.

Most research on payout and returns on investments do not, however, substantiate the claims that these individuals have made. For example:

- Research that the Council on Foundations commissioned shows that foundations could have maintained a 6.5 percent payout rate from 1950 to 1998 and would have still increased their assets by 24 percent.
- A study conducted at Harvard University on the investment returns of 200 of the nation's largest foundations found that they earned an average return of 7.62 percent, while paying out an average of only 4.97 percent.
- A new analysis that US Bancorp's Piper Jaffrey presented at a recent meeting of Northern California Grantmakers found that an investment portfolio made up of 70 percent equity stocks and 30 percent government bonds earned nearly an inflation-

adjusted 8 percent return from January 1980 through December 2002.

- Lincoln Investment Planning, Inc. reports that the S&P 500 earned an average annual return of 10.2 percent from 1926 through December 2002. Investments in small stock companies yielded an average return of 12.2 percent for the same period.

Further, IRS data show that many foundations annually receive new infusions of money beyond returns on investments, including new contributions from individuals and profits from real estate holdings. Assuming that the only source of revenue for foundations is returns on investments simply does not reflect the reality of the philanthropic sector. And considering that the foundation sector has more than quadrupled in size over the past 25 to 30 years, it is mathematically impossible that a percentage or two increase in foundation payout would drain foundation assets and bankrupt the sector.

- Donor-advised fund payout: There is currently no payout minimum for donor-advised funds. There should be a minimum grants payout from donor-advised funds, established at a 6% level comparable to the payout rate that should be required of foundations. Considering the substantial tax breaks that DAFs receive—and their recent proliferation—they must be required to provide some minimal return to society, as everyone is impacted by the lost tax revenue from these charitable vehicles.
- Philanthropic social equity: Foundations need to better address the needs of disadvantaged and disenfranchised populations—and the nonprofits that serve them. Toward that end, there should be more foundation grantmaking devoted to social justice organizing and advocacy, significantly higher proportions of grantmaking devoted to

racial/ethnic minorities, low-income populations, immigrant populations, the disabled, gay/lesbian/bisexual/transgender communities, and a willingness to make grants to smaller organizations as opposed to the current propensity of many foundations to make only a few large grants to a small number of large nonprofit recipients.

In 2002, civil rights and social action nonprofit organizations received only 1.7 percent of all foundation grant dollars. Minority populations in general are underserved by foundations. Grants designated for African Americans/Blacks amounted to only 1.9 percent of all grant dollars in 2002; for Hispanics/Latinos the figure was 1.1 percent; for the disabled, 2.9 percent; the homeless, 1 percent; single parents 0.1 percent; and gays and lesbians, 0.1 percent. These are the groups of people who have been hardest hit by discrimination in society, and they are entitled to receiving a greater share of philanthropic dollars.⁶

Despite the fact that the overwhelming majority of nonprofit organizations in the United States are financially small institutions, nearly half of all foundation grant dollars was given out in grants that were larger than \$1 million in 2002. Only 18 percent of all grant dollars were given through grants that were smaller than \$100,000. These data suggest that foundations are not supporting the countless small, community-based organizations that the nation's most disadvantaged communities and populations depend on for critical human services and political representation.

- Maintain and support small foundations: While some very small foundations may very well be economically impractical, NCRP does not believe that small foundations are any less accountable or probative than large foundations, and in many cases, because of their

⁶ The Foundation Center. *Foundation Giving Trends*, 2004.

smallness and localism, they are more responsive to disadvantaged constituencies than others. Therefore, NCRP calls for maintaining and working with small foundations—and resisting calls for establishing and raising arbitrary minimum capitalization levels for foundations.

The scandals and abuses in foundations that have been reported in the press are not exclusive to small foundations. Foundations in all parts of the country and of all sizes have been engaged in illegal and/or unethical behaviors, according to these press accounts and the foundations' IRS filings. It is irresponsible to pass blame for the recent foundation scandals from the entire foundation sector to just one segment of the sector, as some nonprofit and foundation leaders are attempting to do. Doing so is inaccurate, irresponsible, and unethical.

Maximizing Foundation Support for Justice and Democracy

- Encourage democratic participation: Foundations should be encouraged to support nonprofit public policy advocacy, community organizing, nonpartisan voter registration drives, and civic engagement. It is perfectly legal for them to do so, and these activities do more to advance a broad public interest agenda than most service organizations and programs that foundations currently support.
- Foundation investment activism: Foundations invest hundreds of billions in corporate shares, giving them the opportunity of voting their proxies on critical matters of corporate governance, corporate accountability, and other corporate policies. The failure of foundations to take these affirmative steps with proxy actions results in missed opportunities for social change. NCRP encourages foundations to use their powers as shareholders to promote social

change. Unfortunately, the majority of foundations do not take advantage of this position of power that they currently hold.

- Promote mission-based investing: It makes social and economic sense for foundations to devote part of their investments to mission-based investment options such as community loan funds, equity funds, and other charitable instruments. Mission-based investing should be a standard component of a foundation accountability regime.
- Prevent portfolio concentrations: Foundations should not invest more than a very small proportion of their investments in any one particular corporation, as the law currently calls for, they should desist in asking for exceptions to that standard, and those foundations that have received approval to circumvent this standard should return to the philanthropic norm of preventing such investment concentrations.

The experience of the David and Lucille Packard Foundation is a great example of why foundations should avoid such concentrations. The majority of the foundation's investments was held in Hewlett-Packard company stock. The economic boom of the 1990s—fueled in large part by the technology sector—boosted the foundation's assets to around \$10 billion. Following the economic downturn in 2001—which hit the technological sector especially hard—the foundation's assets shrank by \$8.3 billion, forcing Packard to eliminate entire grantmaking program areas and lay off staff members.

Conclusion

Current regulations, laws, and oversight are clearly ineffective. The drumbeat of scandalous stories in the nation's newspapers will not stop anytime soon. But it is not the responsibility of the media to police the philanthropic sector. Responsibility rests with the government, at both the state and federal level. Not only do the

current laws and regulations need to be actually enforced, but stronger and more relevant laws and regulations are needed to reflect the current realities that both foundations and the charities that they support are facing.

NCRP was created nearly 30 years ago, which was the last time the U.S. Congress took an active interest in holding foundations more accountable to their grantees and the general public. We are encouraged that the Senate Committee on Finance is returning to these very important issues, and look forward to an ongoing dialogue that we hope will strengthen philanthropy so that it can better serve the people and communities who need it the most, as well as remain true to the U.S. citizens who bear the brunt of tax breaks that support the philanthropic sector.

Thank you again for the opportunity to address the Committee. It has been an honor and a privilege.