Foundation Tax Punishes Good Deeds

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Key Takeaways

- The OBBBA changes a flat tax (1.39%) on private foundation's investment income to a progressive one based on asset size, where larger foundations pay a higher rate up to 10%.
- Dramatic tax increases will undoubtedly lead to less funds available for charitable investment in public services, resulting in increased reliance on government subsidies, infrastructure, and welfare programs.
- The revenue generation is minimal compared to the good foundations do. The foundation tax will raise about $16 billion in revenue over the next ten years. Private foundations gave six times that amount in 2023 alone.

With a tight timeline to land the One Big Beautiful Bill Act (OBBBA) on the President's desk, Congress risks letting a poorly conceived idea slip through the cracks: a tax on private foundations. Despite flying under the radar, this provision would curtail the efforts of private charities that dedicate hundreds of billions of dollars per year to worthy causes. With so many other revenue raisers out there, it should be cut from the final bill.

Federal law requires grantmaking foundations to pay out 5% of their assets each year, to pay full income tax on unrelated business income (UBI), and to pay a 1.39% federal tax on investment income. OBBBA adds some well-crafted reforms (a floor to corporate charitable contributions, and closing some loopholes on UBI) but it would convert this flat tax to a progressive one based on asset size, where larger foundations pay a higher tax rate up to 10%. This tax increase will have unintended consequences, sweeping thousands of community and faith-based foundations into its scope. Large and bad are not the same thing (particularly when it comes to charitable endeavors). The Senate should avoid setting a precedent for wealth taxes and remove this tax increase.

What are private foundations?

Private foundations differ from public charities and face stricter regulatory and financial requirements. Public charities often crowdsource funding from society at large (from billionaires to the family down the street), government grants, or other nonprofits. Private foundations, on the other hand, often receive a large portion of their funding from small groups of individuals or a single philanthropist.

Both public charities and private foundations are organized under section 501(c)(3) of the Internal Revenue Code, making them exempt from federal income tax liability, and donations to them from the public are also tax-deductible. Of the over 1.8 million registered nonprofits in the United States, roughly 7% are classified as private foundations that are run and funded by a small number of people. Many of these foundations award funds to other nonprofits to carry out boots-on-the-ground charitable work instead of doing so directly.

Private foundations play an important role in providing local services in need, shifting the burden away from local governments and taxpayers. For example, by May 2020 during the height of the COVID-19 pandemic, more than 500 community foundations across all 50 states had already responded by distributing funds within the community. Philanthropic funding for critical pandemic response services reached $20 billion by the end of 2020.

What would OBBBA do?

OBBBA would replace the existing flat excise tax of 1.39% on net investment income of private foundations with a progressive tax based on the wealth, or total assets, of the foundation.

This tax would be in addition to the existing legal requirement that private foundations charitably distribute at least 5% of their assets annually. They are also subject to various regulations on the use of their funds intended to ensure that they serve to benefit the public.

The OBBBA contains further restrictions for private foundations that are intended to close loopholes and prevent abuse of the private foundation designation. First, lawmakers have included a new floor on corporate charitable deductions in the bill. This would require companies to contribute a minimum of 1% of their taxable income to claim the existing deduction for charitable contributions. The provision would be in addition to a contribution ceiling corporations currently face that limits deductions to only 10% of the corporation's taxable income. Second, the bill would change the treatment of unrelated business income (UBI), which is taxable for nonprofits. OBBBA would classify fringe benefits such as transportation as UBI and exempt publicly available scientific research from UBI. Finally, the bill would expand

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an existing 21% excise tax on the salaries of nonprofit employees earning more than $1 million annually. Current law applies this excise tax to only the top five highest paid employees whereas OBBBA would apply the tax to all employees exceeding the earning threshold.

While these reforms to corporate deductions, UBI, and salaries could protect the integrity of private foundations, the bill's tax hike is an unnecessarily punitive measure. The OBBB proposal would move the current flat 1.39% tax on foundations' net investment income to a dramatically increasing progressive tax. Under the proposal, the rate would remain 1.39% for foundations with below $50 million in assets, but double to 2.78% for those with between $50 million and $250 million in assets, more than triple to 5% for foundations with assets between $250 million and $5 billion, then climb dramatically to 10% for foundations with above $5 billion in assets. The assets of related organizations will be included in the calculation and also subject to the new tax rate. This would be in addition to the minimum distribution requirement and strict regulatory requirements that these organizations already face.

What effect would this have?

This proposal is included in the bill in large part due to frustration (not unjustified) on the part of House Ways and Means Committee leadership about the political activities of a handful of nonprofits. Unfortunately, the proposal will also hurt thousands of community and faith-based charities. Half of all U.S. private foundations bring in less than $250,000 in revenue annually, with many of these foundations focused on providing support for specific communities. Dramatic tax increases will undoubtedly lead to less funds available for charitable investment in public services, resulting in increased reliance on government subsidies, infrastructure, and welfare programs. Religious organizations in particular could also fall victim as the 15 largest private foundations give roughly 12% of their social safety net funding to faith-based groups.

This proposal also sets a troubling precedent for a progressive wealth tax, which acolytes on the Left have repeatedly proposed. Given that the tax is measured by asset size not income, and is intended to have the greatest effect on large private foundations that may be funded by a single or family donor, this tax would have the same effect as a wealth tax. In fact, some of the leading proponents of a wealth tax, such as UC Berkeley Professors Emmanuel Saez and Gabriel Zucman, have proposed taxing private foundations to punish "concentrated individual power." An NTUF report found that a wealth tax would devastate private charitable activity.

Policymakers should avoid the appearance of signaling that upward mobility and building assets is frowned upon by both political parties in the United States. Punitively taxing private foundations could accelerate an existing trend away from private foundations and toward other vehicles which do not have the disclosure and distribution requirements to which private foundations are subject. Yet, with private foundations feeling pressure from Republicans and donor advised funds (DAFs) already being targeted by Democrats, the U.S. may end up discouraging charitable giving through the tax code instead of ensuring it.

The Joint Committee on Taxation (JCT) estimates that the foundation tax proposal will raise about $16 billion in revenue over the next ten years. Private foundations gave six times that amount in 2023 alone. Furthermore, because the tax would effectively fall upon investment income—which can sharply vary with the investment decisions a given foundation might make—the revenue collections associated with this tax could prove to be volatile. Americans are currently some of the most generous givers in the world, and it would be a shame to undermine that trait for a relatively modest and potentially fluctuating amount of additional tax revenue.

What alternatives exist?

Existing law dictates how private foundations operate, and serves as an effective safeguard against bad behavior for the vast majority of them. Private foundations exist under a robust legal framework with distribution requirements, a ban on political activities, and requirements to have a board of directors and transparency in finances and operations. However, as the OBBBA shows, there may still be targeted reforms or technical fixes for Congress to consider that both protect and bolster trust in private foundations without a punitive and progressive tax.

It is important to recognize that guidelines and procedures for revocation of nonprofit status are likewise a guardrail against abuses of power. Take, for example, when conservative-leaning nonprofits were unfairly targeted by the IRS in the infamous Lois Lerner case of 2014. The political targeting of these organizations because they sympathize with right-of-center causes was a gross misuse of power.

If Republicans need to reduce deficits in the OBBBA, they can do so in much more neutral and effective ways. Keeping the TCJA's reasonable SALT cap, for example, would prevent a $321 billion federal tax policy preference from underwriting fiscally irresponsible states. Phasing out the Green New Deal tax breaks will be beneficial too.

Conclusion

The actions of a few prominent left-of-center nonprofits should not lead to a presumption that the entire community of nonprofits is guilty of bad behavior. Policymakers have generally recognized that punishing specific organizations through the tax code would end up harming many other religious and community-based foundations that do much of the work government cannot do. Furthermore, it could set the precedent for politically motivated targeting of organizations and wealthy taxpayers.

Targeted reforms to strengthen the integrity of the charitable sector will better protect incentives to give. It is in the best interest of taxpayers and those most in need for policymakers to avoid adding progressive tax rates on foundations based on their asset size.

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