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Private Foundations: The Trick

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The next time you read about a rich person donating $100 million to charity, you should be aware that this seemingly generous gift may never actually reach the institutions that need it. The chances are that the donation is being used to set up a private foundation. The gift will earn the donor a full deduction against income or estate taxes. But the little-understood trick of this form of philanthropy is that the $100 million that launched the foundation need never go to charity.

Here's how the law works. Under what is known as the "Five Percent Rule," the Internal Revenue Service requires private foundations to spend 5 percent of their assets annually, but only rarely is that obligation met wholly by making direct grants. Some large foundations typically pay out about 3 percent of their assets each year in the form of charitable gifts and divert 2 percent to administrative expenses and the like. Since even a mediocre money manager should be able to average a 5 percent return on a foundation's principal, the IRS is in effect requiring that the foundation spend only its income plus capital gains. None of the principal need go to an active charity that provides services. The donor will still be taking the full charitable deduction, just like an ordinary contributor who writes a check to support a charitable cause. What is more, since private foundations can go on forever, the original gift can survive in perpetuity. This fact encourages some foundations to create large bureaucracies over the years.

Even in good times, this situation would be ethically questionable, but in the current economic climate, it's much worse. Government support of nonprofit organizations is being cut back throughout the country and at every level of government. The economy has been floundering for more than two years, and charitable contributions have shrunk accordingly. Always more sensitive to business cycles than the rest of the nation, New York City has been especially hard hit. Nearly all of the city's nonprofit institutions—among them the New York Public Library and many museums and hospitals—are as hard-pressed for funds as they have been at any time since the Great Depression. One might think that private foundations, having greatly enlarged their assets during the boom years of the 1990s, would now step forward and voluntarily exceed the 5 percent threshold. Very few have.

It seems clear that some of the families that set up the foundations and the executives hired to run them are more concerned to protect their assets and preserve their bonuses than to improve the public good and carry out the purposes for which the foundations were ostensibly created.

The Charitable Giving Act recently proposed by Representative Roy Blunt, a Missouri Republican, and the Tennessee Democrat Harold Ford would modify the statutory “Five Percent Rule” so that only charitable contributions, not administrative expenses, could be used to meet the 5 percent requirement of the IRS. According to the National Committee for Responsive Philanthropy, the Blunt-Ford measure would mean that an additional $4.3 billion annually would go to charities providing services. Admirable as the Blunt-Ford legislation

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