

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

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Key Words: Economic and Legislative Effects, Changes from 1974-1986, Management and Investment Strategies

### A FOUNDATION PROFILE

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 explains the role and behavior of foundations with particular attention to changes following the passage of the Economic Recovery Act of 1981. This 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 foundation 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.

### THE ROLE OF FOUNDATIONS IN SOCIETY

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. In this year all foundations distributed over \$8 billion (current dollars), primarily in the form of grants, to nonprofit areas such as research, education, community needs, and cultural programs.

Foundations typically originate and receive donations from a single wealthy individual, family, or sometimes a corporation. Other 501(c)(3) nonprofit organizations, on the other hand, typically rely on funding received from a wide variety of public sources. In addition, 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 grantmaking and activity, a foundation invests its endowment to realize a return on assets that will fulfill the payout requirement and often enable the foundation to grow and exist permanently.

Through the distribution of charitable dollars and initiatives, foundations represent an example of pluralistic forces effectively impacting American society. In essence, the Government grants donor deductibility and sacrifices tax revenue on foundation income in exchange for charitable dollars and initiatives. While the tax-exempt endowment grows for the future, the foundation gives only a percentage of it 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 they provide, they not only represent pluralism in society, but also elitism. In light 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.

In 1987, approximately 32,700 "nonoperating" foundations existed. The analyses in this paper will focus only on "nonoperating" private foundations, as opposed to "operating" private foundations. Nonoperating foundations hold 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 \$100 million and more in fair market value of assets, held 52 percent of 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, the fair market value of assets increased by 63 percent. Interestingly, from 1979-87 the Gross National Product (GNP) increased by only 21 percent. This indicates a significant level of growth for the foundation sector during this time period. (All dollar amounts, rates, and percent changes throughout the text are calculated using 1982 constant dollar figures).[3]

### 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 interact in a totally competitive market environment. Thus, they do not always face the same economic incentives and constraints.[4]

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. They do possess 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.

### THE TWO PAYOUT REQUIREMENTS

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 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 involved the regulation of foundation activities. Debates, typically on foundation freedom, have focused

on ideas such as limiting either the existence or the tax-deductibility of a foundation.

With the passage of the Tax Reform Act of 1969, Congress instituted the first charitable payout requirement for private foundations. It required that foundations charitably distribute a given amount each year which was to equal the greater of either "adjusted net income" or a fixed percentage of fair market value of assets. [5] 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 charitable payout requirement from the 1969 Act tended to restrict the financial independence of foundations and allowed for relatively little financial flexibility over time. 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 foundation 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 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 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 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. Thus, the change seemed to create a more favorable investment environment, particularly for the smaller foundations, since smaller foundations tend to hold a greater proportion of fixed-income yield investments that earn proportionately high realized income.[6] 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, at least 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 tax law change of 1981 in achieving the goal of increased long-run foundation distributions.

## THE PAYOUT RATE

To examine the charitable distribution trends of private foundations, rates of payout performance were calculated.[7] To calculate the payout rate the amount of (adjusted) qualifying distributions[8] was divided by the amount of the monthly average of noncharitable-use assets. Figure A displays payout trends from 1974-87. Typically, the payout percentage 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.

FIGURE A - Private Foundation 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  
(1) 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 1974-1982 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[9] 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. This number equaled an impressive 291 percent for foundations with under \$1 million in assets.

### 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 assets, 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.[10]

Figure B shows the rates of return for the years 1983-87.[11] The data show that the total rate of return differs 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 goal of long-term capital appreciation of the endowment. They also possess the resources necessary to devote to skillful

investment and risk management. These larger organizations tend to maintain a more diversified portfolio with a greater proportion of relatively lower income yield, higher risk, and higher growth common stock.[12] 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. Data from 1984 were not sampled; therefore, 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 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.

However, the 1987 data 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 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.[13] NII includes long-term capital gains whereas ANI does not. Figure C shows the various NII yields for different size groups for selected years 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

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 (1) FMV = Fair Market Value

**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

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

**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

(1) 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 both 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 line items in the years following 1983 were not edited.

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

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.[15]

**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.

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 their assets grew. 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 smallest 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 \$1 million and more in assets, 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

**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
<b>\$1 under \$1M</b>	<b>4,175,342</b>	<b>3,402,739</b> -18.5	<b>3,732,473</b> + 9.7	<b>3,735,229</b> +.1	<b>4,173,666</b> +11.7	<b>4,383,611</b> +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
<b>\$1 under \$1M</b>	<b>868,673</b>	<b>767,527</b> -11.6	<b>552,069</b> -28.1	<b>801,152</b> +45.1	<b>648,972</b> -19.0	<b>792,847</b> +22.2	<b>803,460</b> +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

- (1) a) Dollar amounts are in thousands (000s).  
b) Dollar amounts are constant 1982 dollars obtained by using the implicit price deflator.
- (2) The 1979 total represents the true total for nonoperating foundations. However, the amounts for each of the sub-totals in 1979 represent the amount for all foundations (nonoperating and operating). This is due to limitations in the 1979 data.
- (3) 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."

foundations actually increased assets more than distributions. These reverse patterns help to show the effect of the 1987 stock market "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 these changes.[16]

**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 smaller 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. They tend to distribute proportionately large amounts in the present, based, in part, on 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.

#### ACKNOWLEDGMENTS

The author would like to extend her thanks to several individuals from the Statistics of Income Division who made important contributions to this paper and provided helpful suggestions. Among these are Jim Harte, who calculated weights for matched data files, Steven Libster, who provided SPSS programming assistance, Perry Dias and Adrienne Bell, who provided operations support, Nat Shaifer, who designed the tables of data, Jeri Mulrow, who designed graphics for the presentation of the paper, Beth Kilss and Wendy Alvey, who coordinated the presentation and publishing 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. Unless otherwise indicated, the stratification of the groups by asset size is not adjusted for inflation. This preserves the size classification by current dollars.

- [4] For a more detailed discussion of the economic behavior of foundations please refer to the extended version of this article. See: Meckstroth, Alicia, "Foundations as Investors and Distributors of Tax-Exempt Charitable Dollars, 1974-87," Statistics of Income and Related Administrative Record Research: 1990, Dept. of Treasury, IRS, 1990.
- [5] 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.
- [6] 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.
- [7] 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.
- [8] 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.
- [9] 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".
- [10] Salamon and Voytek, Ibid.
- [11] 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.
- [12] Salamon and Voytek, Ibid.
- [13] 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.
- [14] 1979 is the first year sampled that includes fair market value figures.
- [15] 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. Interestingly, from 1982-87, the number of large foundations increased at a faster rate than the number of small foundations when using both the current and constant dollar stratifiers for asset size.
- [16] After stratifying the size-groups by 1982 constant dollar assets, the data show similar results. Please refer to the extended version of this article for 1) Figure G, which shows percent changes using constant dollar stratification, and 2) a more complete analysis of this method.[4]

Note: Please refer to the extended version of this article [4] and the recently published Compendium for discussions concerning data sources and limitations. See: Compendium of Studies of Tax-Exempt Organizations, 1974-87, Dept. of Treasury, IRS, Statistics of Income Division, 1990.