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PKF O'CONNOR DAVIES
ACCOUNTANTS AND ADVISORS

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## Private Foundations Bulletin

# Understanding the Net Investment Income Excise Tax

The hopes of foundation managers for tax reform of the net investment income excise tax were again dashed when Congress late last year failed to enact the proposed simplification of the excise tax to a flat tax of 1.4%. Although the flat tax was included in the draft of ***Public Law No. 115-97, an Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018*** (originally introduced as the "Tax Cuts and Jobs Act"), the provision was dropped from the final enacted bill. This was the second time that Congress failed to act on this, as a similar set of events took place under ***The America Gives More Act*** of 2015.

With the uncertainty of any future tax reform, foundations are best served through a clear understanding of the current structure of the excise tax, the complications involved with planning for the excise tax under the two-tiered system, and the practical considerations to keep in mind.

### How to Qualify for the Reduced Excise Tax on Net Investment Income

Private foundations under the current law are afforded the opportunity to reduce their net investment income excise tax from 2% to 1% by meeting certain requirements. To qualify for the reduction, the foundation must meet <u>both</u> of the following requirements:

1. The amount of the current year's qualifying distributions must equal or exceed the sum of:
    - The foundation's current year's net value of noncharitable-use assets multiplied by the prior five (5) year average distribution ratio; and
    - 1% of the foundation's net investment income for the current year.
2. The foundation must not be liable for any tax under the minimum distributions rules for failure to meet its minimum distribution requirements for any of the prior five (5) years, also known as failure to distribute income.

### The Challenge of Estimating the Net Value of Noncharitable Use Assets

As the formula in requirement 1 above relies, in part, upon the current year's net value of noncharitable-use assets, there is a level of estimation that must be undertaken by foundation managers which can prove to be challenging:

> The net value of noncharitable-use assets is calculated as the fair value of assets not used directly in carrying out charitable, etc. purposes, less acquisition indebtedness applicable to those assets, less cash deemed held for charitable activities.

Because the fair value is calculated, in general, as an average of the monthly fair values of noncharitable-use assets including the value on the last day of the year, the calculation must be continuously updated to ensure that the foundation remains on target. If the foundation's assets do not usually fluctuate significantly during the year, this estimation can be much easier to make.

### Managing to the Reduced Excise Tax: Practical Considerations

As a requirement, a foundation must pay out roughly 5% of its corpus on grants and certain expenses related to charitable activities as qualifying distributions. A foundation that fails to pay out the distributable amount in a timely manner is subject to a steep excise tax of 30% on the undistributed income. Making sure the foundation does not fail to distribute enough income in any particular year should be a foundation manager's top priority. Once the 5% threshold is met, a foundation manager may choose to "manage" to the reduced 1% excise tax.

Foundation managers should be advised that "managing" to the 1% may not be beneficial if the amount of tax savings in a given year is less than the amount of additional qualifying distributions that must be made. Furthermore, striving to qualify for the 1% reduction could have an impact on future years as each year that a foundation gives above and beyond the threshold to qualify for the 1% reduction in excise tax, the average distribution ratio also increases, thus making it more difficult to qualify for future reductions in years that may have significant investment income.

It is important to remember that many foundations give above and beyond the 5% each year, and their charitable distributions and endeavors, in general, are of utmost importance irrespective of qualifying for the reduction in tax or not.

### The Takeaway

In conclusion, we hope that the understanding of the net investment income excise tax presented in this bulletin will help to facilitate both foundation managers and board members to discuss fully the implications of the amounts of qualified distributions made during a given year have on its excise tax.

### Contact Us

We welcome the opportunity to speak with you about any questions you may have regarding this newsletter. Please contact us:

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