

YEAR-END TAX LAW SIMPLIFIES TAX RATE ON NET INVESTMENT INCOME FOR PRIVATE FOUNDATIONS

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The federal spending legislation passed by Congress in late December and signed by President Trump on December 20, 2019 includes a long-sought change to the tax rate for the excise tax on net investment income for private foundations.

Private foundations (generally, 501(c)(3) organizations that are not broadly publicly supported) are subject to an excise tax on their net investment income (dividends, interest, and net realized capital gains). Prior to the change in the law, the tax rate was either 1% or 2%, depending on the level of the foundation's grantmaking in its current year as compared to its grantmaking over the previous five-year period. The variable tax rate structure was intended to incentivize increasing grantmaking, but it also had unintended and sometimes unfavorable consequences. The private foundation sector has long sought a simplification of the tax rate structure to a single, fixed rate.

The new law establishes a single, fixed tax rate of 1.39% on the net investment income of private foundations.

The rate change is effective for tax years beginning after the effective date of the new law (which was December 20, 2019).

[The percentage selected was deemed by tax law writers to be approximately revenue-neutral for the federal government.]

Possible Planning Strategies for Private Foundations

Private foundations that have significant investment income and for whom the excise tax is a substantial expense may wish to consider some prudent tax planning strategies.

Private foundations with fiscal years other than the calendar year have the most opportunity for planning strategies based on timing.

Managing the sale date for investments with sizable gains

One strategy to consider would be to manage the date of the sale of investments with large capital gains built in. Consider the example of a private foundation with a fiscal year ending on September 30, 2020 that would be subject to the 2% rate for that year. Given the manner in which the effective date applies, if the foundation waits until after September 30 to sell assets with large built-in capital gains, the lower rate of 1.39% will apply. (Of course, the foundation's leaders would need to factor in other considerations including, but not limited to, market conditions in deciding whether deferral of a sale is prudent.)

Considering a change in fiscal year

Depending on a private foundation's specific circumstances, the foundation's leaders may wish to consider a change in the foundation's tax year to take advantage of the new tax rate sooner. For example, if a private foundation has a fiscal year that ends on September 30, the new 1.39% tax rate will not apply until its year ending September 30, 2021. However, if the foundation were to change its tax year to the calendar year effective December 31, 2019, the new 1.39% tax rate would apply to its new tax year ending December 31, 2020. For a fiscal-year foundation that expects to have very large investment income (including capital gains) subject to the 2% tax rate, the foundation's leaders may wish to consider a change in the foundation's tax year. A foundation considering such a change should do so only under the advice of its tax and legal counsel and should consider other possible implications.

Conclusion

The new fixed excise tax rate of 1.39% is a welcome change for most private foundations, and the manner in which its effective date is structured creates some potential planning opportunities – particularly for private foundations with fiscal years other than the calendar year.

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