

New tax legislation establishes flat tax on investment income of private foundations

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On December 20, 2019, President Trump signed into law the Further Consolidated Appropriations Act, 2020. Under this law, private foundations will be subject to a flat tax on their **net investment income** and the prior two-tier tax system is abolished.

Under prior law, domestic private foundations were subject to a 2 percent tax on their net investment income, but this tax could be reduced to 1 percent under certain circumstances. Specifically, a private foundation would enjoy the lower rate in any taxable year in which it made qualifying charitable distributions equal to or greater than the sum of (a) the assets of the foundation not used in charitable programs or activities multiplied by the average percentage payout for the five immediately preceding years plus (b) 1 percent of the foundation's net investment income for the year at issue. The purpose of the two-tiered rate was to provide an incentive for private foundations to make larger charitable distributions than would otherwise be required under the private foundation minimum distribution rules.

As amended, the law now provides for a flat tax of 1.39 percent of a domestic private foundation's net investment income. Although this simplifies the law, it also reduces the prior incentive for private foundations to give away more than the required minimum distributions. Foundations that consistently qualified for the reduced tax rate under prior law will see this as a tax increase and may note the reduced incentive to distribute more than the minimum required distribution. Foundations that have not qualified for the reduction will welcome the simplification and reduced, flat tax rate.

This amendment is effective for taxable years beginning after December 20, 2019, so for calendar-year foundations this law would be effective beginning January 1, 2020.

Foreign charities that are considered private foundations were already subject to a flat tax of 4 percent on gross investment income from US sources (whereas the tax on domestic private foundations is on net investment income from all sources). The 4 percent flat tax on foreign private foundations has not changed under the new law.

If you have questions about whether and how this new flat tax may affect you or your private foundation, please contact us.

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What is net investment income?

Net investment income is generally defined as gross investment income from interest, dividends, rents, payments with respect to securities loans, and royalties, plus capital gain net income, less expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of gross investment income. In calculating capital gain net income, capital losses can only be used to offset current capital gains and may not be carried forward or carried back; as such, a prudent foundation manager may consider optimizing the disposition of assets to apply current capital losses against current capital gains. Unrelated business income is not included in the calculation of net investment income, as it is separately taxed as income from a regular trade or business.

Authors

Helen S. Cheng

PARTNER | SAN DIEGO, SAN FRANCISCO

Private client and tax

 +1 619 564 6140

 helen.cheng@withersworldwide.com

Steven J. Chidester

PARTNER | RANCHO SANTA FE

Private client and tax

 +1 858 400 1304

 steven.chidester@withersworldwide.com