

Simplification of the Net Investment Income Tax for Private Foundations

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On December 20, 2019, President Trump signed into law changes to the private foundation excise tax on net investment income under Section 4940 of the Internal Revenue Code.[\[1\]](#)

For purposes of Section 4940, net investment income is the excess of gross income from interest, dividends, rents and royalties (“gross investment income”), plus capital gain net income, over expenses paid or incurred in the production or collection of gross investment income or for the management of property held for the production of gross investment income.[\[2\]](#) Prior to the new legislation, Section 4940 imposed an excise tax of 2% on the net investment income of most domestic tax-exempt private foundations.[\[3\]](#) This tax rate could be reduced to 1% if a foundation made certain charitable distributions during the tax year equal to or greater than the sum of (a) the assets of the foundation for the tax year multiplied by its average percentage payout for the five tax years preceding that year, plus (b) 1% of the foundation’s net investment income for the tax year. In order to qualify for the 1% rate, the foundation also could not be liable for any taxes under Section 4942 (taxes on failure to distribute income) for any of the previous five tax years.

The new legislation streamlines the two-tiered tax rate regime by eliminating the 1% rate and its requirements and instead imposing a flat 1.39% rate on the net investment income of private foundations. The new 1.39% rate is effective for tax years beginning after December 20, 2019, and, therefore, will affect private foundations with calendar-based tax years in 2020. It is expected that the 2020 Form 990-PF will be revised to reflect these changes.

Private foundations are no longer able to qualify for a reduced 1% rate on their net investment income under the amended Section 4940, thus, the tax rate incentive to increase qualified distributions has been eliminated. However, these changes reduce the complexity and administrative burden of calculating the tax under a dual-rate system. Private foundations that were previously not able to meet the requirements for the 1% rate will benefit from both the lower tax rate and the simplified tax compliance.

[\[1\]](#) See Division Q of H.R. 1865, the “Further Consolidated Appropriations Act, 2020.”

[\[2\]](#) I.R.C. § 4940(c).

[\[3\]](#) Foreign private foundations are subject to a 4% excise tax on gross investment income from U.S. sources. I.R.C. § 4948(a). H.R. 1865 did not affect the excise tax on foreign private foundations.

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