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Harvey I. Lapin

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PRIVATE FOUNDATIONS—TO BE OR NOT TO BE?

HARVEY I. LAPIN*

INTRODUCTION

All organizations or entities located or otherwise connected to this country are generally subject to its taxation and are covered by the provisions of the 1954 Internal Revenue Code. Section 501 of the Code,¹ however, provides exemption from taxation for specific types of organizations. Under subsection (c)(3) of that section the following organizations may be exempt:

Corporations, and any community chest, fund, or foundation organized and operated exclusively for religious, charitable or scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.²

This exemption status may be modified or in some other way affected by other sections of the Code. This article is concerned primarily with some of these sections³ which were recently added to the Code by the provisions of the 1969 Tax Reform Act.⁴ Prior to a consideration of these specific sections, however, it would be helpful to review the history of the charitable foundation movement.

* Member of the Illinois Bar.

1. All sections discussed in this article refer to the Internal Revenue Code of 1954.

2. INT. REV. CODE OF 1954, § 501(c)(3). These organizations will hereinafter be referred to as "charitable foundations" or "foundations."

3. INT. REV. CODE OF 1954, §§ 507-09, 4940-48.

4. Pub. L. No. 91-172, § 101(a)(b), 83 Stat. 487 (codified in INT. REV. CODE OF 1954, §§ 507-09, 4940-48).

BACKGROUND OF THE FOUNDATION

The spirit as well as the intent of charitable foundations has changed remarkably over the years. In England, where the foundation movement started, John Stuart Mill defined a charitable foundation more than a century ago as :

Money or moneys worth assigned in perpetuity or for some long period, for a public purpose, meaning by public, a purpose which whatever it may be is not the personal use and enjoyment of an assignable individual or individuals.⁵

This definition basically described an organization of the type known today as the special purpose charitable trust. It is not, however, broad enough to cover the grand American charitable foundations of modern times such as the Rockefeller or Ford Foundations. These foundations often have wider latitude in their purposes. For example, the purpose clause of the Rockefeller Foundation provides that it is "to promote the well being of Mankind throughout the world." Because of their broader purposes, American foundations have delved much further than their English counterparts into areas of research, prevention and discovery rather than relief.

A popular misconception in the United States is that all charitable foundations were created for tax saving motives. In fact, most of the larger charitable foundations were created prior to the year 1917 when charitable contributions were first allowed as tax deductions.⁶ It was not until the early 1940's that the type of foundation which is normally thought of as tax-motivated became common. These foundations were usually organized by corporations or wealthy families. The primary difference between these foundations and earlier foundations was that the tax-motivated foundations did not have a corpus; basically, these foundations were considered conduit in nature as opposed to endowment types. Of course, the formation of foundations has increased substantially in recent years. This trend has resulted in increased scrutiny by Congress⁷ and the executive branch of Government.⁸ On the basis of this review,

5. J. S. Mill, *The Right and Wrong of State Interference with Corporation and Church Property*, JURIST, Feb., 1833.

6. Act of Oct. 3, 1917, ch. 63, § 700, 40 Stat. 300, 319.

7. See, e.g., H.R. SELECT COMM. ON SMALL BUSINESS, SUBCOMM. NO. 1, TAX EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print Dec. 31, 1962; Oct. 16, 1963; March 20, 1964); H.R. SELECT COMM. ON SMALL BUSINESSES, SUBCOMM. NO. 1; TAX EXEMPT FOUNDATIONS; THEIR IMPACT ON SMALL BUSINESSES (Comm. Print 1964).

8. U.S. DEPT' OF THE TREASURY, PRIVATE FOUNDATIONS: REPORT TO THE CONGRESSIONAL TAX COMM. (Comm. Print Feb. 2, 1965) [hereinafter cited as TREASURY REPORT].

statutory provisions affecting the operation of certain types of charitable foundations were proposed and adopted as part of the Tax Reform Act of 1969.

TYPES OF FOUNDATIONS

The specific types of foundations at which this legislation was directed basically fall into five classes.

1. The first is known as General Purpose Foundations. In this classification are covered all of the large, well-known foundations such as the Rockefeller and Ford Foundations. These foundations, which are operated in a professional manner with professional staffs, actively support many research projects in the areas of education, health and welfare.

2. The so-called Special Purpose Foundation is usually created by will or trust instrument to serve a specific charitable purpose. The early foundations in England were cast in this mold.

3. The Company Sponsored Foundations are usually set up by publicly held corporations for the purposes of channelling the donations of the company. Except for those that are associated with the large corporations, their activities are usually confined to the local community and often are directed to those interests which are likely to benefit the corporation itself.

4. The Community Foundation is in the nature of an endowment fund, the income being derived from a specific community. They are normally set up in trust form and administered by local banks.

5. Finally, the so-called Family Foundations are the smaller foundations, usually set up by living individuals to channel their current giving. Prior to the 1969 Tax Reform Act, the primary benefit derived by these foundations was the ability of the donor to currently deduct the amount donated to the foundation while still controlling the time of the payment to his various favored charities.

These foundations were frequently used by their donors as vehicles to assist or supplement the donor's outside activities in a profitable manner. It was this type of activity which ultimately led to the corrective legislation enacted in 1969.

Reform Proposals

During the early 1960's, Congressman Wright Patman, Chairman of Subcommittee No. 1 of the Select Committee on Small Business of the House of Representatives, conducted a series of hearings and investigations on the activities of charitable foundations. The Patman Committee

was concerned primarily with the possible abuses that these foundations permitted. The hearings and investigations resulted in the publication of various reports on foundations.⁹ These reports were quite detailed and contained substantial amounts of information for students of the foundation phenomenon. The primary impact of the issuance of this report, however, was its effect on the Treasury Department and their recommendations for legislation.¹⁰

On February 2, 1965, the Treasury Department issued the Treasury Department Report on Private Foundations. This Report is of particular interest to those who wish to understand the reasons for most of the new provisions in the 1969 Tax Reform Act applicable to private foundations. Accordingly, a review of the pertinent portions of this Report would be beneficial for the purposes of this article.

As a practical matter, the summary of the Report¹¹ succinctly states the prime areas covered in the Report; the remainder of the Report extensively amplifies those areas. The summary begins with an appraisal of private foundations based principally on inquiries into the character of the contribution which private foundations made to private philanthropy and an analysis of the validity of the general criticisms which have been leveled against these foundations. The discussion is premised on the basic proposal that private philanthropy plays a special and vital role in our society. Surprisingly, the Treasury Department views the private foundation's role in philanthropy in an approving manner:

Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own vents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from

9. See note 7 *supra* and accompanying text.

10. See note 8 *supra* and accompanying text. In the Treasury Report it is interesting to note that while the Department indicates some reliance on the Patman Committee hearings, it also goes out of its way to illustrate the Patman Committee's limited scope:

[The Patman] Committee met with Treasury officials on several occasions, and was a valuable source of informed opinion, but conclusions and recommendations of this Report are those of the Treasury Department and are, of course, based on facts and views drawn from many additional sources.

TREASURY REPORT 4 n.6.

11. *Id.* at 5.

one charitable area to another. They can hence constitute a powerful instrument for evolution, growth and improvement in the shape and direction of charity.¹²

Having discussed this facet of private foundations, the main criticisms aimed at the private foundation movement are outlined. Three broad criticisms have been directed at private foundations: 1) interposition of the foundation between the donor and the active charitable pursuit results in undue delay in the transmission of the benefits to be derived from charitable contributions; 2) foundations are becoming a disproportionately large segment of our national economy; and 3) foundations represent dangerous concentrations of economic and social power.

The Report points out that because of these criticisms some persons have argued that a time limit should be imposed on the lives of all foundations. The Treasury's conclusions with regard to these criticisms are very interesting:

Analysis of these criticisms, however, demonstrates that the first appears to be susceptible of solution by a measure of specific design and limited scope, the second lacks factual basis, and the third is, for the present, being amply met by the foundations themselves¹³

The Report then goes on to consider major problems revealed by the Treasury study of private foundations.

DEFINING THE PRIVATE FOUNDATION

"Private Foundations," for purposes of the Report, are defined as follows:

(1) Organizations of the type granted tax exemption by section 501(c)(3) (that is, generally, corporations or trusts formed and operated for religious, charitable, scientific, literary or educational purposes, or for testing for public safety or the prevention of cruelty to children or animals), with the exception of:

(a) Organizations which normally receive a substantial part of their support from the general

12. *Id.*

13. *Id.* Compare notes 22-44 *supra* and accompanying text discussing Treasury Department proposals for legislative measures of specific design and limitation on the activities of private foundations with the Treasury's conclusions regarding these criticisms. Perhaps, by such limitation the Department achieved a result inconsistent with its stated intention.

public or governmental bodies ;

(b) Churches or conventions or associations of churches ;

(c) Educational organizations with regular faculties, curriculums, and student bodies ; and

(d) Organizations whose purpose is testing for public safety ; and

(2) Nonexempt trusts empowered by their governing instruments to pay or permanently to set aside amounts for certain charitable purposes.¹⁴

Contrast this definition with that contained in section 509(a) of the 1954 Internal Revenue Code as amended by the Tax Reform Act of 1969 :

(a) GENERAL RULE—For purposes of this title, the term ‘private foundation’ means a domestic or foreign organization described in section 501(c)(3) other than—

(1) an organization described in Section 170(b)(1)(A) (other than in clauses (vii) and (viii)) ;

(2) an organization which—

(A) normally receives more than one-third of its support in each taxable year from any combination of—

(i) gifts, grants, contributions or membership fees, and

(ii) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in an activity which is not an unrelated trade or business (within the meaning of section 513), not including such receipts from any person, or from any bureau or similar agency of a governmental unit (as described in section 170(c)(1)), in any taxable year to the extent such receipts exceed the greater of \$5,000 or 1 percent of the organization’s support in such taxable year, from persons other than disqualified persons (as defined in section 4946) with respect to the organizations, from governmental units

14. *Id.* at 3.

described in section 170(b)(1)(A) (other than in clauses (vii) and (viii)), and

(B) normally received not more than one-third of its support in each taxable year from gross investment income (as defined in subsection (e)).

(3) an organization which—

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specific organizations described in paragraph (1) or (2),

(B) is operated, supervised, or controlled by or in connection with one or more organizations, described in paragraph (1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2); and

(4) an organization which is organized and operated exclusively for testing for public safety.

For purpose of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).¹⁵

The approach taken in the Reform Act definition is the reverse of a normal definition because it negatively defines private foundations by a series of exclusions. This approach, of course, may not provide an easy understanding of what a private foundation is to the average layman, or for that matter, to the average attorney or accountant. In addition, one is not particularly impressed by the constant requirement of this section to refer to other sections of the 1954 Code to determine what in fact is being defined.

With a degree of perseverance, however, it may be possible to deter-

15. INT. REV. CODE OF 1954, § 509(a).

mine what type of organization a private foundation may or may not be. Section 509(a) begins by providing that "Private Foundations" cover a domestic or foreign organization described in section 501(c)(3) other than specific exceptions. For convenience, subsection (a)(4), relating to "an organization which is organized and operated exclusively for testing for public safety," will be eliminated from discussion. This exception is obviously limited in scope and only applies to two specific organizations.¹⁶

The other exceptions in the definition have more general application. Subsection (a)(1) refers to the first group of organizations excluded from private foundation status: "organizations described in section 170(b)(1)(A) (other than in classes (vii) and (viii))" which are contributions to organizations which were previously deductible to the extent of 30% of an individual's income under prior law and to the extent of 50% under present law. This exception is primarily intended to apply to organizations such as 1) churches, 2) educational organizations, 3) hospital or medical research organizations, 4) organizations holding funds for the benefit of colleges and 5) governmental units.

The second exception is designed to exclude from the classification those organizations which may not be included in the group covered by the first exclusion, but which should have been included in that group because of the extent of the public support received by their exempt functions. There are specific tests to determine public support under the second exclusion. These tests provide that the organization must normally receive less than 1/3 of its support from investment income and more than 1/3 of its support from the public in the form of gifts, grants, membership fees and gross receipts from such related income sources as ticket sales and admission fees other than from "disqualified persons."¹⁷ For this purpose, support includes all forms except capital gains. Gross investment income includes only dividends, rents, interests and royalties. Obvious problems in this section are to determine what constitutes membership fees when all members do not have voting rights and what constitutes a grant rather than a contract for services. Organizations which meet these mechanical tests for exclusion will, of course, not

16. See *Underwriter's Laboratories, Inc. v. Commissioner*, 135 F.2d 371 (7th Cir.), cert. denied, 320 U.S. 756 (1943).

17. The term "disqualified persons" is defined in section 507(d). Basically, the definition covers a substantial contributors to the foundation, a foundation manager, an owner of more than 20 percent of an entity which would qualify as a substantial contribution, a member of the family of the preceding class as determined under specific attribution rules, a business entity more than 35 percent owned by any or all of the preceding, and, in some instances, government officials.

be classified as private foundations and the remaining sections discussed will not be applicable to them.

The third exclusion, defined in subsection (a)(3), relates to organizations which are not to be treated as private foundations because, as support-type organizations, they are "organized" and "operated" exclusively for the benefit of one or more of the organizations described in the first and second exclusions and are operated, supervised or controlled by or "in connection with" such organizations and not organizations which would be a disqualified person. The Senate Committee Report indicates that the "organized" and "operated" test is to apply to existing organizations as of the effective date of the passage of the provision.¹⁸ If an organization does not meet the test on that date, it must proceed with defined procedures to conform its instruments and activities to the statutory test.

The legislative history behind the phrase in the third exclusion, "or in connection with," is of some interest to students of a lobbyist movement. In the House Bill, this exception was confined to organizations operated in connection with a *single* section 509(a)(1) or (2) organization.¹⁹ When this exception was made, various colleges and universities throughout the country apparently put pressure on the Senate Finance Committee to extend it to cover organizations operated, supervised or controlled in connection with two or more schools. The probable intent of this extension was to cover certain types of organizations that work with the school, *i.e.*, an organization which tests for college entrance purposes. In conference the language was further broadened to its present form. Section 509(a)(3)(B) now provides that it can be operated, supervised or controlled by or in connection with one or more organizations described in paragraph (1) or (2) and which are not disqualified persons.

In addition to this obvious extension of the third exclusion there was also a discussion between Senator Javits and Senator Long on the Senate floor concerning the relationship between the second and third exclusion.²⁰ Javits cited the example of a membership organization which might meet the intent of the second exclusion as a public-type charity but which would be technically ineligible because it received too many disqualifying grants. He inquired of Senator Long if the organization should still qualify under this second exclusion if it set up a controlled corporation to receive the grants and transfer to that controlled corporation enough of its own

18. S. REP. No. 91-552, 91st Cong., 1st Sess. 57 (1969).

19. H.R. 13270, 91st Cong., 1st Sess. (1969). See H.R. REP. No. 91-413, 91st Cong., 1st Sess. 91 (1969).

20. 115 CONG. REC. 37629-30 (1969).

exempt activity to use up those grants. Senator Long responded by pointing out that the second corporation would certainly qualify under the third test since it literally would meet all the requirements of that separate provision and that the first organization, as a result of transferring the disqualifying branch, would not qualify under the second test as being publicly supported. Despite this interesting colloquy on the Senate floor, the Treasury Department has not taken a particularly liberal attitude in its proposed regulations for these sections.²¹

There is an extension of these provisions in the third exclusion to organizations other than section 501(c)(3) organizations. Thus, for purposes of the third exclusion, an organization described in the second exclusion is also deemed to include organizations exempt under sections 501(c)(4), 501(c)(5) and 501(c)(6); however, such organizations must meet the same financial support test of section 509(a)(1) or (2).²² Code section 508 places the burden on the organization to obtain exclusion from the private foundation provision by requiring every section 501(c) organization to file a notice requesting such status. If an organization does not file, it will automatically be considered a private foundation.

Once an organization has been classified as a private foundation, it must amend its governing instrument to provide specific provisions prohibiting it from engaging in any of the activities covered by the changes in the law. These modifications for organizations in existence as of January 1, 1970,²³ must be made by December 31, 1971.

PROHIBITIONS

Once an organization has been defined as a private foundation, there are a number of activities from which it must refrain. These activities were special concerns of the Treasury Department's study of private foundations.

Self-dealing

The first problem area that concerned the Treasury Department was that of self-dealing:

Some donors who create or make substantial contributions

21. Proposed Treas. Reg. § 1.509(a)—5(b), 35 Fed. Reg. 17857 (1970).

22. This exception was designed to meet organizations such as the American Bar Foundation, a section 501(c)(3) organization, which is operated in connection with the American Bar Association, a section 501(c)(6) professional association.

23. See INT. REV. CODE OF 1954, § 508(e).

to a private foundation have engaged in other transactions with the foundation. Property may be rented to or from it; assets may be sold to it or purchased from it; money may be borrowed from it or loaned to it. These transactions are rarely necessary to discharge foundation's charitable objectives; and they give rise to a very real danger of diversion of foundation assets to a private advantage.²⁴

After reviewing the history of this problem, the Treasury Report recommended legislative changes which would substantially prohibit such transactions:

The effect of this recommendation would, generally, be to prevent private foundations from dealing with any substantial contributor, any officer, director, or trustee of the Foundation, or anybody related to them, except to pay reasonable compensation for necessary services and to make incidental purchases of supplies.²⁵

These recommendations resulted in the passage of Code section 4941 in the Tax Reform Act of 1969.²⁶ This section replaces section 503 of the 1954 Code as far as private foundations are concerned. However, section 503 has been left in the Code and is still applicable to qualified pension plans under section 401 and similar type organizations under section 501(c)(17).²⁷ The theory for prohibition under section 4941 is substantially different from the loss of exemption approach used in

24. TREASURY REPORT 6. This area of concern was raised as early as 1950 when the House of Representatives approved a bill which would have imposed absolute prohibition on most financial dealings between foundations and donors or related parties. H.R. 8920, 81st Cong., 2d Sess. (1950). The measure finally adopted, after discussion with the Senate, prohibited only loans which did not bear a *reasonable* rate of interest and did not have *adequate* security, or substantial purchase of property for more than *adequate consideration* or substantial sales of property for less than *adequate security* and certain other minor transactions. Revenue Act of 1950, ch. 994, § 331, 64 Stat. 906, 957. The Treasury Report pointed out that fourteen years of experience with this section (now codified at INT. REV. CODE of 1954, § 503(c)) demonstrated that the imprecision in that statute made enforcement difficult and abuses general.

25. TREASURY REPORT 6.

26. The substantive provisions affecting private foundations added by the Tax Reform Act are codified with the other provisions applicable to exempt organizations at sections 501 to 526 of the 1954 Code. The prohibition sections, however, are excise taxes and accordingly are reported in that series of sections starting at section 4940.

27. Section 503 provides that a cover organization would lose its exemption and that charitable contribution deductions would thus not be allowed if the organization engaged in any of a specific number of prohibited types of self-dealing transactions with substantial contributors, family members or the like. Certain arms-length standards, however, were put into the section, and, as a result, the substantial contributor and foundation could usually avoid the prohibitions contained in the section.

section 503. First, objective standards are set out governing transactions between disqualified persons and private foundations. Secondly, rather than imposing the loss of exemption on the foundation which engaged in certain prohibited acts, the new provisions control by imposing a tax on acts of alleged self-dealing to both the self-dealer and the foundation manager.

Acts of self-dealing are specifically defined in the statute to include any of the following direct or indirect underlying transactions: 1) a sale or exchange or a leasing of property between a private foundation and a disqualified person; 2) the lending of money or other extension of credit between a private foundation and a disqualified person; 3) furnishing of goods, services or facilities between a private foundation and a disqualified person; 4) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; 5) transfer or use by or for the benefit of a disqualified person of the income or assets of a private foundation; and 6) agreement by a private foundation to make any payment of money or other property to a government official.²⁸

If a disqualified person engages in any of these areas of self-dealing with a private foundation, he could be subject to several levels of taxation and penalties. The first level of taxes provided for under section 4941(a) is "Initial Taxes." Initially, a tax of five percent is imposed on the self-dealing organization, and a two and one-half percent tax could be imposed on the foundation manager unless it is shown that his act was not willful and done with reasonable cause. Under section 4941(b) there is a possibility of additional taxes if, after the imposition of the initial tax, the act of self-dealing is not corrected within the period defined by section 4941(e) (4) (ninety days after the date of mailing of a notice of deficiency by the Internal Revenue Service). If the act of self-dealing is not corrected during that period, an additional tax equal to 200 percent of the amount involved may be imposed on the self-dealer. In the case of a foundation manager, an additional tax equal to 50 percent of the amount involved, but not in excess of \$10,000, may be imposed.²⁹

Those familiar with the complexities of the Internal Revenue Code will not be surprised that the section contains some additional clarification and exceptions to the general rules of self-dealing. These special rules,

28. For purposes of the self-dealing provision, "government officials" is defined in section 4946(c).

29. These additional penalties, though in varying rates and amounts, may be imposed under all the violation sections discussed in this article. Because of the similarity of the rules for imposition of the penalties, they need not be reiterated.

provided at section 4941(d)(2), can be paraphrased in the following manner:

1. A sale or exchange of property between a private foundation and a disqualified person can include a transfer of real or personal property which is subject to a mortgage or a similar lien which the foundation assumes or which had been placed on the property within the ten-year period immediately preceding the date of transfer.

2. The lending of money without interest or other charge by a disqualified person to a private foundation which is used exclusively for the exempt purposes will not be considered an act of self-dealing.

3. The furnishing of goods, services or facilities without charge by a disqualified person which are used exclusively for the exempt purposes shall not constitute an act of self-dealing.

4. The payment of reasonable compensation or reimbursement for expenses to a disqualified person for reasonable and necessary services required to carry out the exempt purposes shall not constitute an act of self-dealing provided, however, that such compensation shall not be paid to a government official.

5. Exchanges of securities between a foundation and a corporation which is a disqualified person pursuant to a reorganization under which the foundation receives substantially the same type of securities with the same fair market value will not be considered self-dealing.

6. Certain payments may be made by the foundation to government officials without being considered acts of self-dealing. These are provided specifically at section 4941(d)(2)(G).

Failure to Distribute Income

The second area of concern was the problem relating to an individual obtaining the immediate benefit of the charitable deduction while using the foundation as a vehicle for deferring the ultimate benefit to the charitable cause. After outlining the problem and reviewing the present legislation³⁰ and its problems, the Treasury Report recommends the

30. The Treasury Report outlines the purpose of section 504:

Taking note of the disadvantages to charity of permitting unrestricted accumulations of income, Congress in 1950 enacted the predecessor of section 504 of the present Internal Revenue Code, which denies an organization's exemption for any year in which its income accumulations are (a) 'unreasonable' in amount or duration for accomplishing its exempt purposes, (b) used to a 'substantial' degree for other purposes, (c) invested in a way which 'jeopardizes' the achievement of its charitable objectives. The indefiniteness of the section's standards, however, has rendered this provision difficult to enforce. Two changes in the law are needed for private foundations which do not carry on substantial active charitable endeavors of their own.

TREASURY REPORT 6.

following:

First such private foundations should be required to devote all of their net income to active charitable operations (whether conducted by themselves or by other charitable operations) on a reasonably current basis. To afford flexibility, the requirement should be tempered by a 5-year carryforward provision and a rule permitting accumulation for a specified reasonable period if their purpose is clearly designated in advance and accumulation by the foundation is necessary to that purpose.

Second, in the case of nonoperating private foundations which minimize their regular income by concentrating their investments in low yielding assets, an 'income equivalent' formula should be provided to place them on a parity with foundations having more diversified portfolios. This result can be accomplished by requiring that they disburse an amount equal either to actual foundation net income or to a fixed percentage of foundation asset value, whichever is greater.³¹

These recommendations led to the passage of section 4942, entitled "Taxes on Failure to Distribute Income," which sets forth objective standards for income distribution. A private operating foundation is specifically exempted from these provisions.

A foundation must meet two basic requirements in order to be classified as a private operating foundation. First, it must spend substantially all (normally over 85 percent) of its adjusted net income directly for the exempt activity as opposed to mere donations. (This is known as the income test). Second, it must either: 1) devote over one-half of its assets to exempt activity (normally over 65 percent) either directly (or indirectly through a holding company), or 2) direct expenditures of at least two-thirds of "Minimum Investment Income" (6 percent of the market value of the foundation's folio), or 3) receive substantially all its support (excluding gross investment income) from the general public and from five or more unrelated exempt organizations (not more than 25 percent from any one) with not more than one-half of total support coming from its gross investment income.

If a foundation does not qualify as a "private operating foundation," it is subject to the specific rules of section 4942. First, there is imposed a tax at a rate of 15 percent on any undistributed income. To arrive at undistributed income, "adjusted net income" must be computed. This

31. *Id.*

is done by adding to gross income (after the exclusion of capital gains and inclusion of related and unrelated income) tax-exempt interest and short term gains. The effect of this modification is that long-term gains are excluded from income. In computing short-term gains, the foundation may elect to use December 31, 1969 values as its basis. After this adjusted gross income is determined, all expenses are deducted, including those attributable to tax-exempt income which has not been included in gross income. "Minimum investment return" is determined by applying the prescribed rate of a six percent return against assets other than those used for the exempt purposes (investment assets). These assets, where possible, are to be valued at monthly intervals. The "distributable income" then represents the greater of adjusted net income or the minimum investment return. This figure is further reduced by any section 4940 excise tax and unrelated business tax. The resulting sum is known as the "distributable amount" which must be distributed within one year after it is earned in the form of "qualifying distribution" in order to escape tax.

"Qualifying distributions" are those distributions to accomplish the exempt purpose, including even distributions to other section 501(c)(3) organizations or disqualified persons if they are distributed within a year. Also included are expenses to maintain the charitable program. After qualifying distributions are offset against the distributable amount, any balance is subject to the tax.

Other provisions of section 4942 may be involved in reducing the tax base. Qualifying distributions in the next tax year may be carried back to offset against the preceding years undistributed income, and excess qualifying distribution for a year may be carried over for five years to be used in those years in which there is taxable undistributed income. In addition, there is a deficiency dividend procedure similar to the personal holding provisions to be used in situations where the deficiency resulted from a good faith, incorrect valuation of assets.

A special rule provides for accumulation of undistributed income for up to five years with the permission of the Internal Revenue Service if a project can better be accomplished by accumulation rather than yearly distributions.

Business Ownership

The third area of concern was the involvement of foundations in the active conduct of business enterprises. In its Report, the Treasury was concerned with foundations that could directly or indirectly affect operat-

ing business by owning an interest of sufficient magnitude to permit involvement in business affairs :

Serious difficulties result from foundation commitment to business endeavors. Regular business enterprises may suffer serious competitive disadvantage. Moreover, opportunities and temptations for subtle and varied forms of self-dealing—difficult to detect and impossible completely to proscribe—proliferate. Foundation management may be drawn from concern with charitable activities to time-consuming concentration on the affairs and problems of the commercial enterprise.³²

The recommendation of the Treasury is as follows :

For these reasons, the Report proposes the imposition of an absolute limit upon the participation of private foundations in active business, whether presently owned or subsequently acquired. This recommendation would prohibit a foundation from owning, either directly or through stock holdings, 20 percent or more of a business unrelated to the charitable activities of the foundation (within the meaning of sec. 513). Foundations would be granted a prescribed reasonable period, subject to extension, in which to reduce their present or subsequently acquired business interests below the specified maximum limit.³³

On the basis of these recommendations, Congress enacted section 4943 of the 1954 Internal Revenue Code entitled "Taxes On Excess Business Holdings."

Section 4943 had no direct basis in prior law. The problem that the Treasury was concerned with, however, would seem to be adequately covered by the prohibitions of self-dealing and minimum investment return which were previously discussed. In addition, from a policy viewpoint these problems were already covered by other sections of the prior law applicable to almost all exempt organizations such as the unrelated business sections.³⁴ There is even some possibility that this new section will interfere with the prior sections. The theory of section 4943 is to initially impose a tax of five percent on business holdings held in excess of "Permitted Holdings." The foundation's permitted holdings of a corporation's stock is usually a maximum of 20 percent reduced by any voting stock held by a disqualified person which, for purposes of this

32. *Id.* at 7.

33. *Id.*

34. INT. REV. CODE of 1954, §§ 511-15.

section, is defined to include related foundations.³⁵ If all disqualified persons owned less than 20 percent of the voting stock, the foundation may also include any nonvoting stock it owns as a permitted holding. If the foundation and disqualified persons together own less than 35 percent of the corporate stock, and the corporation is controlled by others, the foundation and disqualified persons can have permitted holdings of up to 35 percent. There is a *de minimis* rule which allows a foundation to own two percent of all types of corporate shares in any corporation no matter how much is owned by the disqualified persons. Of course, there are attribution rules for the purpose of including indirect stock holdings³⁶ within the computation; however, these rules do not apply to include an income or remainder interest in corporation stock of the foundations. There are similar prohibitions concerning ownership of partnership interests and an absolute prohibition against operation by the foundation of a sole proprietorship.

Functionally, related or passive trade of businesses which receive 95 percent of their income from passive sources are excluded from the definition of "business enterprise" in the statute, and a controlling interest in that type of organization can freely be held by a foundation. The practical result of this exception is to allow a foundation to own an interest in a building which is leased to others since all it would receive would be a passive interest. However, the situation is not clear where there is an outstanding debt on the building. Since the prohibitions are absolute, the new section contains some detailed transitional provisions for present holdings to be divested.³⁷

Speculative Investments

The fourth area covered in the Treasury Report relates to investments by foundations:

Some foundations have borrowed heavily to acquire productive assets. In doing so, they have often permitted diversions of a portion of the benefit of their tax exemptions to private parties, and they have been able to swell their holdings markedly without dependence upon contributors. Certain foundations have made loans whose fundamental motivation was the creation of unwarranted private advantage. The borrowers, however, were beyond the scope of reasonable and administratable

35. *Id.* § 4946(a)(1)(H).

36. *Id.* § 4943(c)(3).

37. *See id.* § 4943(c)(4).

prohibitions on foundation self-dealing, and the benefits accruing to the foundation's managers or donors were sufficiently nebulous and removed from the loan transactions themselves to be difficult to discover, identify, and prove. Some foundations have participated in active trading of securities or speculative practices.³⁸

According to the Treasury these problems would easily be remedied if the following rules were adopted :

First, all borrowing by private foundations for investment purposes be prohibited. Second, that foundation loans be confined to categories which are clearly necessary, safe and appropriate for charitable fiduciaries. Third, that foundations be prohibited from trading activities and speculative practices.³⁹

Consistent with these recommendations, Congress enacted Section 4944 entitled "Taxes on Investments which Jeopardize Charitable Purposes."

The question of speculation investments had been previously dealt with by Congress. In 1950, Congress enacted section 504 of the Code⁴⁰ which was applied to revoke the exemption of any organization exempted under section 501 if it invested income in a manner that would jeopardize the performance of its charitable purpose. Unfortunately, the Internal Revenue Service had little success in enforcing that section.⁴¹

Section 504 was repealed by the 1969 Tax Reform Act⁴² and section 4944 was added to give the Internal Revenue Service control over this problem. Section 4944 deals with the problem in a manner different from former section 504. First, rather than denying exemption, it imposes an annual initial tax of five percent on the amount of the jeopardy investment on the foundation and its manager. Under the new section, the source of funds for the investment can also include corpus and is not limited to income as it was under prior law. The foundation's manager, in order to be subject to taxation, must know of the jeopardy involved and thereafter willfully invest. His liability, while joint and several, is limited to \$5,000 for each investment. The tax continues for each year until the year after the year in which the investment is disposed

38. TREASURY REPORT 7.

39. *Id.* at 9.

40. Revenue Act of 1950, § 331, 64 Stat. 906, 957 (repealed 1969).

41. *See Akron Clinic Foundation v. United States*, 226 F. Supp. 515 (N.D. Ohio 1964); *Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1956).

42. Pub. L. No. 91-172, § 101(j) (15), 83 Stat. 487.

of and the proceeds from any sale are invested in non-jeopardy investments.

The statute itself does not provide a definition for jeopardy investments; to that extent, the new legislation has not really clarified the area. In the Senate report,⁴³ however, it was stated that the purchase of warrants, commodity futures, options and securities on margin are jeopardy investments per se. The provision of the section does exempt from its term "program related investments where the principal purpose of the investment is to further charity rather than to produce income." Examples of this type of investment would be low income housing projects or low interest student loans.

Taxable Expenditures

The final substantive area of concern in the new legislation was not initially discussed in the Treasury Report. However, the subject of taxable expenditures arose during the period between the issuance of that Report and the preparation and submission of the Treasury proposals for tax reform to the House Ways and Means Committee on April 22, 1969. Thus, the following was contained in the Treasury proposals:

Certain specific abuses by private foundations would be prohibited:

. . . .

—engaging in certain political activities, such as voter registration drives.

Foundations would also be required to make available for public inspection information as to grants to individuals, the activities of these individuals, and their work product.⁴⁴

These proposals resulted in the passage of section 4945 of the 1954 Internal Revenue Code entitled, "Taxes on Taxable Expenditures."

Under prior law a foundation which devoted more than an insubstantial part of its activities to carrying on lobbying or other legislative activity or any activities connected with a political campaign could lose its exemption.⁴⁵ Section 4945 uses a different approach and imposes a tax on such activities. If such activities, however, are substantial activities of a foundation, the exemption could still be challenged. This section imposes a ten percent tax on the foundation for taxable expenditures and

43. S. REP. NO. 91-552, 91st Cong., 1st Sess. 45 (1969).

44. CCH 1969 STAND. FED. TAX REP., 2d Extra Ed., Summary of the President's Tax Reform Procedures with a Treasury Technical Explanation (April 23, 1969).

45. See INT. REV. CODE OF 1954, § 501(c)(3).

a two and one-half percent tax on the foundation manager for willful taxable expenditures. Taxable expenditures are defined in the statute to cover lobbying, voter registration drives, grants to individuals for travel, study and like purposes and grants to other organizations exempt under section 501(c)(3). Taxable lobbying expenditures not only include grassroots politics but also communications on legislative matters with employees or members of a legislative body. Fortunately, there are certain exceptions. Some specifically provided for in the statute are:

1. Providing technical assistance to a legislative body in response to a written request;

2. Making available to the results of non-partisan analysis, study or research to the public or lawmakers;

3. Appearances before Congress in connection with legislation affecting the existence, powers and duties, or tax exempt status of the foundations, or deductions of contributions to it.⁴⁶

4. Even though foundations may not directly carry on voter registration drives, they may support organizations making such drives if they comply with specific provisions relating to percentage of support.

5. Travel, study and similar grants to individuals must be made on an objective and nondiscriminatory basis pursuant to procedures approved in advance by the Internal Revenue Service.

6. Finally, there is an exception to the prohibition against grants to other foundations if the foundation exerts expenditure responsibility. This means that the foundation must exert reasonable efforts and establish adequate procedures for determining that the grant is spent solely for the purpose specified, including requiring a full report of how the funds are spent and, most important of all, making a report to the Internal Revenue Service.⁴⁷

Substantively, the Internal Revenue Service is now well armed to deal with the foreseeable problem areas of foundations. It was necessary, however, for Congress to provide certain procedural benefits to both the Service and the taxpayers in order to provide for the orderly operation of the substantive provisions.⁴⁸ The first obvious concern was to provide funds for the increased audit requirements of the new provisions. This was accomplished with the passage of section 4940 which imposes

46. Note that a technical interpretation of this language might not cover the situation where an appearance was made before the Treasury Department on a matter which was not being considered by Congress.

47. See *id.* § 4945(h).

48. This article does not attempt to cover in detail every relevant provision in the Tax Reform Act. All that is intended is to give the reader an awareness of the existence of these provisions.

upon every private foundation a four percent tax on its net investment income.

Additional new requirements have been provided for rules to determine status as a private foundation⁴⁹ and for annual reports or returns,⁵⁰ publication thereof,⁵¹ and penalties for failure to file.⁵² In addition, judicial remedies have been added for those organizations who may not agree with the determinations of the Internal Revenue Service.⁵³

CONCLUSION

The title of this article posed the question of whether to form a foundation which may be classified as a private foundation or to continue in the status of a foundation so classified under the new provisions. Whatever, it is apparent that the Treasury and Congress deemed it necessary to correct certain abuses which had crept into the operation of some foundations. The Treasury summarized the basis for its proposals as follows:

These Treasury Department proposals are based upon a recognition that private foundations can and do make a major contribution to our society. The proposals have been carefully devised to eliminate subordination of charitable interests to personal interests, to stimulate the flow of foundation funds to active, useful programs, and to focus the energies of foundation fiduciaries upon their philanthropic functions. The recommendations seek not only to end diversions, distractions, and abuses but to stimulate and foster the active pursuit of charitable ends which the tax laws seek to encourage. Any restraints which the proposals may impose on the flow of funds to private foundations will be far outweighed by the benefits which will accrue to charity from the removal of abuses and from the elimination of the shadow which the existence of abuse now casts upon the private foundation area.⁵⁴

It might be argued that if the Treasury Department and Congress merely sought by these new rules to prevent diversion of the charitable dollar to non-charitable purposes, the remedy prescribed to accomplish that purpose was unnecessarily complicated and severe. It would almost

49. *Id.* § 508.

50. *Id.* § 6056.

51. *Id.* § 6104.

52. *Id.* § 6652(d)(3).

53. *Id.* §§ 6211, 7422(g).

54. TREASURY REPORT 10.

appear to many practitioners that they have attempted to cure abuses with a cannon blast rather than with constructive legislation. On the other hand, it could be argued that the new rules would not prevent a private foundation that is interested principally in charitable work from continuing to fulfill its charitable purposes and remain a viable entity.

The answer to the question posed is really dependent upon the value of the charitable purpose connected with the foundation. Foundation managers should now give careful consideration to maintaining this status in view of the stringent rules, the increased liabilities and additional reporting requirements. In the event they conclude that maintaining the status is not warranted, then they can make use of the termination provision which Congress was generous enough to include with the other provisions of the 1969 Tax Reform Act.⁵⁵ In any event, the tax motivations for the formation of a foundation, which may be classified as a private foundation, will no longer in and of itself justify a foundation's existence.

55. INT. REV. CODE of 1954, § 507.