

COMMENT ON THE PATMAN REPORT

JAN Z. KRASNOWIECKI † AND ALEXANDER BRODSKY ‡

The Board of Editors of Volume 112 believes that many important and timely issues fail to receive the attention they deserve because the normal format of a law review Article demands extensive research which already overburdened members of the legal profession often cannot afford. The University of Pennsylvania Law Review intends to alleviate this problem by publishing, from time to time, well-considered Comments on current topics by members of the judiciary, teaching profession, and bar. The following Comment analyzes the recommendations of the recent Patman Report dealing with the tax treatment of charitable foundations.

In an address before the New York University Conference on Charitable Foundations, Professor Albert M. Sacks observed: "Concern about philanthropy, and in particular about philanthropic foundations, seems to go through a cyclical pattern: a period of quiet contentment, and then a time of alarm and crisis." Federal and state policy toward private charitable giving, Professor Sacks urged, should pursue a steady course of assessment and reassessment, an "even pace, in quiet as well as unruly times."¹

We should recall this advice now. For we have entered upon another crisis—perhaps, as some would have it, upon "unruly times." The publication in December 1962 of a report by Representative Wright Patman entitled *Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy*² has created an unprecedented stir not only in foundation and tax circles but in the public press.³ There are signs that the issues raised by Representative Patman will not die easily. The Internal Revenue Service has already acted to

† Associate Professor of Law, University of Pennsylvania. B.A. 1951, B.C.L. 1952, M.A. 1955, Oxford; LL.M. 1956, Harvard University. Member, Illinois Bar.

‡ B.A. 1929, M.A. 1933, University of Pennsylvania; LL.B. 1943, Temple University. Member, Pennsylvania Bar. Mr. Brodsky is a member of a special subcommittee of the Exempt Organizations Committee of the Section of Taxation of the American Bar Association formed to study the Patman Report.

¹ Sacks, *Use and Misuse of the Private Foundation*, in NEW YORK UNIVERSITY FIFTH BIENNIAL CONFERENCE ON CHARITABLE FOUNDATIONS, PROCEEDINGS 203, 204 (1961). The last serious crisis in Congress occurred in 1950. See *Hearings on the Revenue Revision of 1950 Before the House Committee on Ways and Means*, 81st Cong., 2d Sess. (1950). It had a fairly mild sequel in certain changes in the Revenue Act of 1950, ch. 994, 64 Stat. 957. There followed several congressional investigations to inquire into alleged un-American activities of charitable foundations. See *Hearings Before a Special Committee To Investigate Tax Exempt Foundations*, 83d Cong., 2d Sess. 2681 (1954); WORMSER, *FOUNDATIONS: THEIR POWER AND INFLUENCE* (1958).

² CHAIRMAN OF HOUSE SELECT COMM. ON SMALL BUSINESS, 87TH CONG., 2D SESS., *TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY* (Comm. Print 1962) [hereinafter cited as CHAIRMAN'S REPORT].

³ See New York Times, Aug. 23, 1962, p. 14, col. 4; Wall Street Journal, Aug. 23, 1962, p. 3, col. 2; Wall Street Journal, Jan. 7, 1963, p. 20, col. 2.

intensify its auditing of tax-exempt organizations and to tighten the reporting requirements.⁴

Although the bulk of the Patman Report is devoted to findings based on a study of 534 tax-exempt foundations covering the period 1951 through 1960, the seventeen recommendations⁵ present the most interesting portion of the Report. It is to these recommendations that this Comment is devoted.

The Report calls for reforms in three principal areas of foundation activity: (1) foundation control of business enterprises; (2) foundation influence over business; (3) administrative supervision over foundations. However, the Report does not remain consistently within the confines of its subject matter. For example, Recommendation 9 would postpone the charitable deduction for any contribution to a foundation until the contributed asset is actually disbursed or distributed by the foundation to some charitable use. Recommendation 11 would confine the charitable deduction to the cost basis or value (whichever is lower) of the contributed asset. Recommendation 12 would deny the five percent corporate charitable deduction in any taxable year during which the corporation has elected subchapter S⁶ treatment, thereby eliminating the advantage of an additional deduction which under present law enures to the benefit of the shareholders. Recommendation 16 would exclude from the adjusted gross estate, upon which the maximum marital deduction is calculated, gifts made to charity, thus reducing the maximum marital deduction.⁷ These recom-

⁴ Treas. Reg. § 1.6033-1(a)(4) (1958), as amended, T.D. 6645, 1963-17 CUM. BULL. 10; see Proposed Treas. Reg. § 1.170-1, 27 Fed. Reg. 10489 (1962).

⁵ CHAIRMAN'S REPORT 133-35.

⁶ Under INT. REV. CODE OF 1954, §§ 1371-77, a small business corporation may elect to be taxed essentially as a partnership.

⁷ This recommendation is related to potential abuse of the charitable foundation device in only one striking instance. Suppose a donor, during his lifetime, creates a charitable foundation in the unincorporated trust form. Under the foundation trust instrument he retains the power during his lifetime, alone or in conjunction with other foundation trustees, to distribute the corpus and income among such charitable objects as he, and they, may from time to time determine. By virtue of an express provision in the "Clifford" sections of the Code, the retention by him of this power does not cause the income of the foundation trust to become taxable to him. INT. REV. CODE OF 1954, § 674(b)(4). However, under the estate tax sections of the Code, the retention of this power by the donor until his death will cause the value of all of the assets contributed by him and the accumulated income thereon to be included in the gross estate. INT. REV. CODE OF 1954, §§ 2036, 2038. There is, in the estate tax sections, nothing corresponding to § 674(b)(4). The value of the contributed assets and accumulated income of the foundation trust, having been included in the gross estate of the donor, will, of course, be deductible under § 2055. The net effect of this inclusion and deduction, however, is to increase the maximum marital deduction available to the donor's estate because such maximum is computed without reference to the deduction for charitable contributions. INT. REV. CODE OF 1954, § 2056(c)(2)(A). Thus, through this arrangement, the donor may have during his lifetime secured the benefit of a deduction or deductions against income for his contributions to the foundation trust and taken advantage of the exclusion from his gross income of the income produced by the donated assets, and yet, upon his death the maximum

mendations are not confined to transactions which directly affect business control or activity, but are addressed broadly to the policy of our present law of charitable giving. This illustrates the Report's basic weakness to stray, sometimes confusingly, beyond the area of immediate concern—foundation impact on the economy.

In preparing this Comment, however, we have been mindful that the Patman Report is not a document written by lawyers for lawyers and that it cannot, therefore, be tested in the first instance by the rigorous standards of precision and consistency demanded of lawyers. Rather, we have felt that an effective evaluation of the Report demands that where the Report fails to make the necessary distinctions, they be supplied; that where it is inconsistent in its recommendations, they be accepted as alternatives; that where it fails to define or narrow the scope of its criticisms or of its subject matter, definitions be proposed which are consistent with the context. In short, we will address our evaluation to the sense which the Report can make, not to the nonsense that may be discovered therein.

I. DEFINING THE ORGANIZATIONS TO WHICH THE RECOMMENDATIONS APPLY

The Report refers to "foundations and charitable trusts" as the objects of the investigation, but does not expressly define these terms.

In exploring Recommendation 1, which places a twenty-five-year limitation on the life of foundations, Representative Patman states: "I believe that all foundations and charitable trusts should be obliged to distribute to charities and beneficiaries [under a program which] . . . will result in the complete distribution of all assets . . . at the end of 25 years of [their] . . . existence." Implicit in this statement is a distinction between organizations which merely administer funds for distribution to charities, and charities which are actively engaged in charitable work. Indeed, Representative Patman's investigation was for the most part confined to organizations of the former sort; the Report indicates that the information was largely obtained from income tax form 990-A.⁸ Speaking generally, this form need not be filed by hospitals, schools, churches, public charities supported in whole or in part by public contributions,⁹ or by those pension, profit-sharing, and stock bonus plans which are qualified under section 401(a).¹⁰

marital deduction available to his estate will be increased by reference to value of the assets contributed by him, for which he had obtained a charitable deduction against income, and by reference to the accumulated income on such assets, which he never included in his gross income.

⁸ See CHAIRMAN'S REPORT 38-50; *cf. id.* at 2.

⁹ Treas. Reg. § 1.6033-1(g) (1958).

¹⁰ INT. REV. CODE OF 1954, § 401(a); Treas. Reg. § 1.6033-1(a)(2) (1958).

These factors, along with the spirit and text of the entire Report, indicate that, instead of encompassing all section 501(c)(3)¹¹ organizations, the Report deals only with organizations which do not engage directly in charitable work, but which distribute funds to institutions and persons that do.

II. FOUNDATION CONTROL OF BUSINESS ENTERPRISES

In his discussion of foundation control of business, Representative Patman does not distinguish clearly between foundations that are independent of their creator and those under the control or influence of their creator in some appropriate tax sense.¹² Thus, some of Representative Patman's recommendations have general application, while others apply only to controlled foundations.

A. Recommendations of General Applicability

1. Recommendations Which Would Discourage Any Foundation Control of Business

In Recommendation 6, Representative Patman states: "In my view, all foundations should be limited to ownership of no more than three percent of the stock of a corporation and should not be allowed to vote stock." We may take this recommendation in the narrow sense, namely, that it calls for a denial of federal tax qualification as a charity and a denial of tax exemption to any foundation which violates the stated limitation. It could, of course, be taken more broadly to call for state and federal laws which would implement the proposed limitation in other, non-tax, ways.

Overlapping and to some extent inconsistent with Recommendation 6 is Recommendation 2 that "tax exempt foundations should be prohibited from engaging in business directly or indirectly." Representative Patman explains the word "indirectly" by stating: "Foundations controlling corporations engaged in business, through the extent of stock ownership in those corporations, should themselves be deemed to be engaged in that business." This recommendation can be given several interpretations. If it calls for denial of qualification as a charity and a denial of tax exemption to any foundation which controls a

¹¹ Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, 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 . . . [shall be exempt from taxation].
INT. REV. CODE OF 1954, § 501(c)(3).

¹² *E.g.*, INT. REV. CODE OF 1954, §§ 671-78 (treatment of grantors and others as substantial owners for tax purposes).

corporation, it overlaps Recommendation 6 and is inconsistent with it, at least with respect to the proposed tests of control. It is, perhaps, more reasonable to suppose that Recommendation 2 is intended to work an expansion of section 512¹³ rather than an expansion of section 504¹⁴ or 503(c);¹⁵ that it is intended to tax to the foundation any income received from a controlled corporation without withdrawing the charitable qualification or tax exemption as to other receipts.

Assuming, *arguendo*, that businesses should not be allowed to remain under foundation control for any period, however short, the approach of Recommendation 2, as we interpret it, seems preferable to the approach of Recommendation 6. Both recommendations would discourage charitable giving of large blocks of stock. Recommendation 6, however, would have a greater tendency to produce this result because, by depriving the donee foundation of charitable status, it would deny any charitable deduction to the donor. Recommendation 2, on the other hand, if interpreted as supposed, would not deny the charitable deduction. Rather, it would tax the foundation on income from a controlled business, thereby influencing the foundation to divest itself of the controlling holdings. Under Recommendation 2, a donor who does not desire to continue his influence over the business, but who would prefer that control should not pass to unknown interests, would clearly be discouraged from making the gift at all.

On the merits, there is little in favor of a policy which prevents foundation control of business for even a short period. The price for such a policy, the discouragement of a substantial amount of charitable giving, is too high, especially when the policy would be applied without regard to other factors, such as the presence or absence of continued control or influence by the donor.

2. Recommendations Which Would Discourage Long-Term Foundation Control of Business

Recommendation 1 is one of Representative Patman's most challenging proposals: "In my view, consideration should be given to a limitation of 25 years on the life of foundations instead of allowing them to exist in perpetuity."

On its face, the recommendation requires the liquidation of all foundations twenty-five years after their inception, regardless of whether the foundation is or is not in a position to make an "impact

¹³ INT. REV. CODE OF 1954, § 512.

¹⁴ INT. REV. CODE OF 1954, § 504.

¹⁵ INT. REV. CODE OF 1954, § 503(c) (prohibited transactions which will deny exemption).

on the economy" in some objectionable sense. This is much too sweeping a reform for the supposed evils which it is designed to curb. For the recommendation to be meaningful, we must assume that it would be applicable only to foundations which control business enterprises. Further, if control of business is the objection, the recommendation should be narrowed to a requirement that the foundation liquidate its controlling interests within twenty-five years of their acquisition rather than that the foundation itself be liquidated.

There are some details which must be supplied even if the recommendation is narrowed in the proposed manner. Should the governing instrument or the terms of the gift have to direct divestiture within twenty-five years in order to obtain the charitable deduction, or should a wait-and-see rule be adopted? What steps should be taken to prevent the divested controlling interest from finding its way into the hands of another foundation for another twenty-five-year period? In addition, Representative Patman clearly envisages that the liquidation of a foundation would be in favor of charitable institutions, yet, surely some of the objections to perpetual control of businesses by the foundations dealt with in the Report are equally applicable to perpetual control by charitable institutions.

A twenty-five year divestiture requirement, properly worked out, may not have as adverse an effect on charitable giving as would the proposals of Recommendations 2 and 6. Taken as an alternative to those proposals, Recommendation 1 merits careful consideration.

B. Tax Treatment of Foundations Under the Control or Influence of Their Creator

Recommendation 9 not only denies a donor any deduction for contributions to a foundation under his control until the contributed assets are actually distributed, but also taxes the controlling donor for income earned by the foundation until put to charitable use.¹⁶ The exact scope of this proposal is unclear. For the test of control, Representative Patman refers us to subpart E of subchapter J of the Code.¹⁷

¹⁶ In my view, a contributor should not be allowed a deduction for payments to a foundation that he controls until the foundation actually uses the money for charity. The foundation should be recognized as being the alter ego of the controlling contributor. Income earned by the foundation should be taxable to the controlling contributor until put to charitable use.

These principles can be implemented by treating controlled foundations the way the tax law now does trusts (Subchapter J, Chapter 1, Internal Revenue Code). . . .

All foundations controlled by the same individual, family, or company should be treated as one, in determining whether control exists or whether the foundations have been used for personal advantage.

CHAIRMAN'S REPORT 133-34.

¹⁷ INT. REV. CODE OF 1954, §§ 671-78.

He states that foundations should be treated "the way the tax law now does trusts."¹⁸

Under the present law, however, the income of a charitable trust is not attributable to the settlor unless he has a reversionary interest which may reasonably be expected to take effect within ten years;¹⁹ unless he has a power to revoke the trust at any time; or unless he may receive the income directly or indirectly without the consent of an adverse party.²⁰ In a private trust, the power to determine the beneficial enjoyment of the corpus or income of the trust will generally open the settlor to taxation upon the income of the trust. This effect, however, is expressly denied in the case of a charitable trust.²¹ Under present law, the fact that a person other than the settlor has considerable control over the distribution of the corpus and income of the trust and over its administration, does not, unless the power can be used for his personal benefit, cause such person to be taxed upon the income of the trust, even when the trust is not a charitable one.²²

It is true that, under existing law, if the foundation is incorporated, the rules applicable to the settlor of a trust under subpart E, subchapter J would not be applicable to the creator of the foundation. However, the extension of these rules to the creator of an incorporated foundation would not work a significant change in the law unless the rules of subpart E, subchapter J were themselves revised. At the present time, if the creator of an incorporated foundation were to provide that the foundation may be dissolved by him, or by anyone else, and its assets distributed to him or for some nonexempt purpose, the foundation would not be given charitable qualification. Indeed, the Treasury Regulations state that, "an organization does not meet the organizational test [of section 501(c)(3)] if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders."²³ Thus, if the creator of an incorporated foundation were to retain, as a formal matter, the powers which would render him taxable under sections 673(a) and (b), 676, and 677 with regard to the income of a trust, the incorporated foundation would not qualify as a charity. Similarly, if anyone other than the creator of an incorporated foundation were to be given the powers which would render him taxable under section 678 with regard to the income of a trust, the incorporated foundation would not qualify as a charity.

¹⁸ CHAIRMAN'S REPORT 134.

¹⁹ INT. REV. CODE OF 1954, § 673(a).

²⁰ INT. REV. CODE OF 1954, §§ 673(a)-(b), 676-77.

²¹ INT. REV. CODE OF 1954, § 674(b)(4).

²² INT. REV. CODE OF 1954, § 678.

²³ Treas. Reg. § 1.501(c)(3)-1(b)(4) (1959).

Thus the only effect of extending the treatment of these sections to the incorporated foundation would be to render the creator (or other persons who have a section 678-type power over the foundation) taxable on all of the income of the foundation, although not distributed to them. At the same time, the foundation, having lost its exemption, would be required to pay a tax at ordinary corporate rates. We do not expose the shareholders of a business corporation to this treatment, and there is no reason to recommend it in this case.

There is a significant difference between the controlling shareholder of a business corporation and the creator or others who have retained control over a corporate foundation. The controlling shareholder of a business corporation does not obtain a charitable deduction for his investments in the corporation. Under present law, however, when an organization has initially qualified as a charitable foundation, a loss of charitable status as a result of subsequent activities or transactions does not disturb the deductions that have previously been obtained by its creator or other contributors.

Retention by the creator or others of rights or powers that would cause the incorporated foundation to disqualify as a charity from its inception should not also cause the creator or others to be taxed on the income of the foundation unless this result can be justified under the rules of corporate taxation.

A different situation is presented when the objectionable relationship to the foundation arises after the creation of the foundation or when the retained control offers a potential for securing private benefits in the future. On this point there is a vast difference in philosophy and result between the rules applicable to trusts and those applicable to the incorporated foundation.

For example, it is no answer to Representative Patman's proposal that the powers listed in section 675 are for the most part covered by section 503(c). Under section 503(c) the incorporated foundation does not lose its charitable status until it has in fact conferred the prohibited benefits upon the creator.²⁴ That the control retained by the creator offered a potential for this is immaterial. Charitable deductions obtained prior to the taxable year in which the exemption is lost are not recalled under section 503(e).²⁵ Even after the loss of

²⁴ Under INT. REV. CODE OF 1954, § 503(a)(1)(A), a foundation will lose its § 501(a) exemption only "if it has engaged in a prohibited transaction." (Emphasis added.) Note that, under the trust rules, the philosophy of waiting until the benefit is in fact conferred is adopted only, and uniquely, in the case of support trusts. INT. REV. CODE OF 1954, §§ 677(b), 678(c).

²⁵ "No gift . . . shall be allowed as a deduction if made to an organization described in section 501(c)(3) which, in the taxable year of the organization in which the gift or bequest is made, is not exempt under section 501(a) by reason of this

the exemption, due to some prohibited transaction which benefits the creator, the creator does not become taxable on the income of an incorporated foundation—as he might be if trust rules were applicable. Representative Patman's proposal to treat controlled foundations "the way the tax law does trusts" has the merit of drawing our attention to a serious shortcoming of the present tax policy towards donor controlled foundations—a shortcoming which is significant without reference to its effect on business growth and competition. It draws our attention, also, to some shortcomings that are directly relevant to business activity. For example, while loans actually made in favor of the creator are covered in section 503(c), the tax exemption is lost only if such a loan is not adequately secured or does not bear a reasonable rate of interest.

Under section 675(3) the grantor of a trust is taxable on its income not only when a loan to him is inadequately secured and bears inadequate interest, but also when the loan was made to him by a trustee who is related, subordinate, or subservient, or when the grantor, as trustee, lends to himself. In this situation, section 503(c) clearly would not deny tax exemption, but section 675(c), if applicable to incorporated foundations, would render the creator taxable on the income of the foundation. It is noteworthy at this point that Representative Patman has strong objections to any foundation which engages in commercial lending,²⁶ and this activity is not, at present, covered by sections 675(2), 503(c), or 504(a)(3). We will discuss the effect of an extension of section 675(1)-(3) to incorporated foundations and Representative Patman's objections to commercial lending, in the next major section of this Comment, "Foundation Influence Over Business."

The effect of section 675(4), however, is directly related to our present consideration of the treatment of foundation control of business when the creator remains in control of the foundation. Under section 675(4)(A) and (B) a grantor of a trust becomes taxable on the income of the trust when any person has the power "in a non-fiduciary capacity" to vote or direct the voting of stock or other securities in a corporation "in which the holdings of the grantor and the trust are significant from the viewpoint of voting control" or when such person has power to control the investment of the trust funds "to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the

section." INT. REV. CODE OF 1954, § 501(e). (Emphasis added.). Treas. Reg. § 1.503(e)-1(c) (1958) offers an example which suggests that the Service will seek to disallow, as to a donor who has participated in the prohibited transaction, any deductions taken by him on prior returns which are still open.

²⁶ "Commercial money lending and borrowing by foundations should be banned." Recommendation 3, CHAIRMAN'S REPORT 133.

viewpoint of voting control." There is no case law construing these provisions, presumably because it has always been comparatively easy to establish that administrative powers are exercisable in a "fiduciary capacity" when other beneficiaries are affected and when there is no clear indication of a contrary intent on the part of the grantor.²⁷ Section 675(4), if extended to incorporated foundations, would presumably continue to have little significance, unless we are willing to say that a retained power in the creator to vote the stock held by a foundation or to direct its investments should be presumed to be exercisable in a nonfiduciary capacity because the only beneficiary, the state, has little time to police its exercise. This presumption touches one of the fundamental issues posed by foundation giving—the extent to which we can, in deciding upon appropriate tax treatment, assume proper policing of foundation activities both at the state and federal level. This topic will be discussed in the last major section of this Comment, "Administrative Supervision Over Foundations."

One further difficulty with the application of section 675(4) to incorporated foundations is that section 675(4) is apparently inapplicable when a grantor has transferred all of the voting stock of the corporation to the trust and so has no further "holdings" in the corporation which can be affected by the manner in which the stock is voted or administered. Representative Patman clearly would not want this situation to remain unaffected by his proposals.

C. Forcing the Creator of a Tax Exempt Foundation Which Controls a Business To Sever His Relationship With the Foundation: A Fundamental Issue of Policy

The proposal in Recommendation 9 to tax the controlling creator on the income of the foundation, at least when the foundation controls a business, raises a fundamental issue which is, perhaps, impossible of resolution.

There are two major effects of foundation control of business which cause concern. One is the dampening effect which such control may have on the business controlled; the other is the unfair competitive advantage which a foundation-controlled business may have over others. It is the second of these concerns which one would expect to be emphasized by the Committee on Small Business, and it was the second which Representative Patman in fact emphasized. But when we address ourselves to the health of the economy in general, both effects of foundation control should be explored.

²⁷ Compare SCOTT, TRUSTS § 185 (2d ed. 1956) and *Carrier v. Carrier*, 226 N.Y. 114, 123 N.E. 135 (1916), and *Lewis v. Hanson*, 36 Del. Ch. 235, 128 A.2d 819 (Sup. Ct. 1957), with *Ditmars v. Camden Trust Co.*, 10 N.J. Super. 306, 76 A.2d 280 (1950), and *State Street Trust Company v. United States*, 263 F.2d 635 (1st Cir. 1959).

Although it would be imprudent to try to explore them here, we can at least note that if the concern is that a business will become moribund in the hands of foundation trustees, the least desirable action is to penalize the creator's personal participation in the running of a business he once owned. If, on the other hand, noncompetitive growth of the business is the concern, there are better solutions, such as the twenty-five-year divestiture requirement. In this respect, some of Representative Patman's suggestions involving unreasonable accumulations of income, particularly Recommendation 15²⁸ dealing with section 531 accumulations by the foundation-controlled corporation, deserve careful thought.

D. Foundation Control of Business and the Dead Hand

Distinguishable from whether the creator's personal participation in the conduct of a foundation-controlled business should be discouraged is the question whether the creator ought to be permitted to control its business policies after his death. Apart from the twenty-five-year divestiture proposal and the proposal prohibiting control of business for any period, Representative Patman has no specific recommendation directed to this question.

Under both federal and state law, the creator of a foundation in trust form can go quite far in leaving directions with the foundation trustees as to how the business will be conducted. Recently, the Pennsylvania Supreme Court held such a foundation a valid charitable trust entitled to exist in perpetuity although the trust instrument directed, *inter alia*, that the trustees vote for the nominees of the existing directors; that they cause the corporation to set aside \$4.00 per share before any bonuses are paid; and that they ensure that the bonuses, if any, are paid in certain proportions between officers and employees.²⁹ Surely these provisions, even if no one has standing to enforce them,³⁰ tend to effect a dynastic perpetuation of a particular

²⁸ Corporations controlled by foundations should be subject to the unreasonable accumulation earnings tax in section 531 of the Code. At present, that tax is imposed where dividends are held back to save tax for stockholders. It should also apply where dividends are held back to save the existence of unreasonable accumulations for foundations otherwise exempt from tax.

CHAIRMAN'S REPORT 134.

²⁹ Scholler Trust, 403 Pa. 97, 169 A.2d 554 (1961), *affirming* 20 Pa. D. & C.2d 318, 333 (Orphans' Ct. 1960).

³⁰ *D'Arcangelo v. D'Arcangelo*, 137 N.J. Eq. 63, 43 A.2d 169 (Ch. 1945); *In re Feinson's Estate*, 196 Misc. 590, 92 N.Y.S.2d 87 (Surr. Ct. 1949); *In re Koffend's Will*, 218 Minn. 206, 216-18, 15 N.W.2d 590, 596-97 (1944) (direction that testator's widow be employed as an officer and voted a salary of \$3,600 upheld, although she was dead at the time of suit). None of these cases, however, involved the question of whether the person designated by the settlor to be elected, employed, or continued in office with the corporation has any right to enforce the provisions of the trust instrument. In *D'Arcangelo* the court stated in dictum that a direction to cause a

management, to discourage the payment of larger dividends, and to encourage the distribution of most of the corporation's income as bonuses to its employees. It could also be argued that because the trust instrument instructs the trustees to assure the foundation of a \$4.00 dividend per share, the net effect is to discourage them from making any further effort to secure larger distributions when these are justified by the earnings of the corporation, and thus to encourage them to let the rest of the earnings go out in bonuses.

III. FOUNDATION INFLUENCE OVER BUSINESS

It is, of course, impossible to distinguish sharply between the issues raised by foundation control over business and those raised by foundation influence over business. However, we have attempted to preserve some such distinction in this Comment to sharpen, if possible, the understanding of the Patman Report.

In Recommendation 3, Representative Patman proposes that "commercial money lending and borrowing by foundations should be banned." This proposal, presumably, covers both lending to the creator and lending to the world at large. We have noted already that Representative Patman's proposal in Recommendation 9, with reference to loans by a foundation to its creator, would go beyond the present law under section 503(c)(1) to the extent that it works an extension of section 675(1)-(3) to incorporated foundations. It would discourage any lending to the creator in a case where the foundation is under his control or the control of related or subordinate parties, even though adequately secured and at a reasonable interest rate.

There is considerable merit to the proposals in both recommendations. The creator of the foundation should not be encouraged to look forward to his foundation as an "easy bank." While the adequacy of the security can be easily determined, it is certainly harder to say what is a "reasonable rate of interest." A low rate of interest which cannot be obtained quickly and easily on the market need not be unreasonable, yet it does put the creator in a business advantage over competitors who do not have an "easy bank." The "easy bank" is,

wholly owned corporation to employ a designated person may be "enforced," but it does not state by whom. The courts draw a distinction between trust directions which evidence merely an intention to guide the trustee in the exercise of his discretion and directions which are intended to give a beneficial interest to some third party. It seems clear that the courts are reluctant to find an intention of the latter sort. It may be that if the third party is a close member of the settlor's family or is a trusted old friend, such an intention will be found to exist. See *In re Hand's Estate*, 349 Pa. 11, 36 A.2d 485 (1944); *In re Platt's Will*, 205 Wis. 290, 237 N.W. 109 (1931); Note, *Testamentary Designation of an Attorney*, 1958 Wis. L. Rev. 322; Krasnowiecki, *Existing Rules of Trust Administration: A Stranglehold on the Trustee-Controlled Business Enterprise*, 110 U. P.A. L. Rev. 816 (1962).

after all, kept going at the expense of all taxpayers.³¹ In this connection, Representative Patman's Recommendation 10,³² which appears to do no more than to restate the accepted policy of section 503(c), should be read as an urgent call for a reexamination of the efficacy of that and similar provisions in the Code, and should not be dismissed lightly.

Recommendation 3, so far as it relates to commercial lending in general, also deserves some consideration. Representative Patman's position, and it does not seem unreasonable, is that foundations can acquire considerable influence over business through their lending.

Representative Patman's Recommendation 4 is that, "A foundation should not be permitted to use its funds to grant benefits to a controlled company's employees." This, he says, is quite a competitive advantage. In view of the fact that employee benefit plans are tax exempt under section 401,³³ this recommendation challenges an established tax policy with ramifications far outside the field of foundation activity. Beyond noting this fact, we feel that comment on the merits would be inappropriate at this time.

Earlier we categorized Mr. Patman's suggestion for a twenty-five-year divestiture requirement as one of the most challenging that he has presented. Perhaps equally challenging are those suggestions addressed to the problem of unreasonable accumulations. In Recommendation 15,³⁴ Representative Patman notes that section 531³⁵ does not reach accumulations of a business corporation the sole stockholder of which is a tax-exempt foundation. This result obtains because the tax is imposed only when the corporation has been "availed of for the purpose of avoiding the income tax with respect to its shareholders." Representative Patman recommends that the tax should be imposed also "where dividends are held back to save the existence of unreasonable accumulations for foundations otherwise exempt from tax."

³¹ See Donald G. Griswold, 39 T.C. 620 (1962).

³² Exemption should be denied if a foundation has been formed or availed of for tax avoidance purposes or to get financial benefits for the contributor. Conversely, a controlled corporation should not be allowed a contribution to a foundation, but instead the payment should be considered as a dividend to the controlling stockholder where the amount is significant and the foundation is unrelated to the business purpose of the corporation.

The tax law says that a foundation's earnings may not inure to the benefit of any private individual. It should be made clear that "individual" includes corporations and trustees.

Contributions made by a foundation in the name of a controlling individual, or in relief of a controlling individual's obligation, should be regarded as using foundation earnings for the benefit of the individual.

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³³ INT. REV. CODE OF 1954, § 401.

³⁴ See note 28 *supra*.

³⁵ INT. REV. CODE OF 1954, § 531.

Obviously, a foundation-owned corporation which plans to embark on a program of expansion is at some advantage over its competitors who have to deal with dividend-conscious stockholders. In addition, although the high purpose and sense of duty of most foundation trustees cannot be questioned, there are exceptions to the general rule. There is no law which prohibits foundation trustees from serving as officers or directors of the controlled corporation. Salaries of officers and directors are challenged openly only by shareholders or by the Commissioner of Internal Revenue if claimed as a corporate deduction, and then only if they are disproportionate to the magnitude of the enterprise. If we are concerned with the competitive advantages which a foundation-controlled business has over others, if we desire to control their growth rather than their atrophy in the hands of a foundation, then Representative Patman's recommendation ought to be taken seriously—at least insofar as his recommendation calls for an extension of section 531 tax to accumulations of income by a foundation-controlled business enterprise.

Recommendation 15 goes further, however, and calls for a rule which would aggregate the accumulations in the business enterprise and the accumulations in the foundation. It is not clear whether the sanction would be to apply the surtax to the accumulations within the corporation only; apply the surtax to the aggregate accumulations; deny a tax exemption to the foundation; or apply some combination of these sanctions. The tax exemption is, at present, denied if the amount accumulated by the foundation is "unreasonable in amount or duration in order to carry out" its charitable functions.³⁶

Representative Patman's investigation showed that accumulations of income reported for the ten-year study period from 1951 through 1960 rose from \$271,615,733 in 1951, to \$906,136,256 in 1960.³⁷ The prohibition against unreasonable accumulations by tax-exempt foundations was introduced into the Code by the Revenue Act of 1950.³⁸ It is interesting to note that the House bill sought to restrict the exemption to income which is actually distributed to charity within two and a half months of the taxable year of receipt.³⁹ The Senate rejected this approach on the ground that it might injure charitable projects.⁴⁰

Unreasonable accumulations within the foundation present, it seems to us, different considerations than those involved in unreason-

³⁶ INT. REV. CODE OF 1954, § 504(a) (1).

³⁷ CHAIRMAN'S REPORT 114-28.

³⁸ REVENUE ACT OF 1950, ch. 944, § 3814(1), 64 Stat. 958 (1950).

³⁹ H.R. REP. No. 12317, 81st Cong., 2d Sess. 40-41, 115-23 (1950).

⁴⁰ S. REP. No. 2375, 81st Cong., 2d Sess. 34 (1950).

able accumulations within the foundation-controlled business corporation. The latter has an immediate impact on business growth and competition. Unreasonable accumulations within the foundation, however, may portend a concentration of economic power in foundations and may reflect a wasteful hoarding of the charitable dollar. This may, or may not, have an adverse effect on the economy. To aggregate the accumulations within both the foundation-controlled business and the foundation itself for the section 531 surtax is, in many ways, to mix apples and pears. There is merit in an attempt to deal with the accumulations at the corporate level. There can be little doubt that the treatment of accumulations at the foundation level should be carefully reviewed, but it is doubtful that the two issues should be confused.

Concerning the treatment of unreasonable accumulations at the foundation level, Representative Patman makes two recommendations that should be given prompt consideration. In Recommendation 14, he wisely suggests that the accumulations of foundations related through common control should be aggregated.⁴¹

Under Recommendation 13,⁴² Representative Patman would have all capital gains of the foundation treated as income for purposes of unreasonable accumulations. The Regulations now provide that gains representing the original spread between the market value of any asset at the time of its donation and the substituted (donor's) basis in the hands of the foundation will not be considered as income for purposes of the rule.⁴³ This seems a reasonable extension of the present policy which would encourage charitable giving by measuring the donor's deduction by reference to market value rather than to his basis. Representative Patman, it should be noted, would rather limit the charitable deduction to the donor's basis.⁴⁴ In view of this, it is rea-

⁴¹ For the purpose of computing the accumulation of income, amounts unreasonably accumulated in corporations controlled by a foundation should be added to the foundation's direct accumulation as if the two were one. The use of subsidiary corporations should not be permitted to cloak actual accumulations

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⁴² For the purposes of figuring the accumulation of income, contributions to a foundation and all capital gains of the foundation should be considered as income, and not capital. Both the original contribution and the income from it are ordinarily available to the foundation without distinction.

This would eliminate a device for avoiding unreasonable accumulation of income: contributions from one donor-controlled foundation to other foundations controlled by the same donor.

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⁴³ Treas. Reg. § 1.504-1(c) (1) (1958).

⁴⁴ [W]here a contribution to a foundation is made in property as distinguished from cash, the deduction would be figured at cost or value, whichever is lower. At present it is figured on value. In all cases, as a result, appre-

sonable to suppose that he would include the original spread between basis and market value at the time of contribution in considering the question of unreasonable accumulations. It is doubtful that the unfair advantage now given to the potential donor who happens to have low basis assets over the potential donor who does not, or the loss in revenue involved, justifies the removal of this encouragement to charitable giving. So long as the policy of such encouragement is adhered to, there is little reason for penalizing the foundation that receives low basis high market value assets by counting the subsequent realization of that spread for purposes of the rule against accumulations.

Quite a different matter are the gains made by the foundation in the sale or exchange of its assets based on the market value of such assets when donated to it. If such gains are not counted for purposes of the rule against accumulations, a foundation can confine itself to "growth" investments with a low income yield and simply grow in size and economic power at both the taxpayer's expense and that of the charitable purposes it is supposed to serve. Yet the Regulations, apparently unsupported by any specific language in the Code, allow, for purposes of the rule against accumulations, the exclusion of gains upon assets held for the production of investment income if reinvested within a reasonable time for the same purpose.⁴⁵

The area of foundation accumulation is in need of further scrutiny and, perhaps, reform. Representative Patman's challenge here should not be dismissed lightly. If accumulations go unchecked, if foundations are allowed to engage in large scale commercial lending, and if foundation speculations on the market are not watched or controlled, such accumulations can have very adverse effects on the economy. Representative Patman has, therefore, wisely presented a recommendation addressed to foundation speculation. Recommendation 8 states: "Another area that needs consideration is that of investments. There is a sharp difference between investing in securities and speculating or trading in securities." There can be little doubt that this area should be carefully reviewed.

ciation escapes tax to the point where high-bracket taxpayers can actually enrich themselves by giving to foundations instead of selling the property.

As an alternative, the difference between value and cost should be added to the contributor's taxable income as a condition to the deduction. At the very least, shouldn't the tax profit on charity giving be eliminated?

Where stock is given to a controlled foundation, the value—for purposes of determining the amount of the deductions—should be reduced by the value of the voting power over the stock that, in effect, has been reserved by the contributor.

Recommendation 11, CHAIRMAN'S REPORT 134.

⁴⁵ Treas. Reg. § 1.504-1(c)(2) (1958). Compare, INT. REV. CODE OF 1954, § 504(a)(1).

Recommendation 7 states: "Standards should be established with respect to foundation behavior in a proxy fight." The tone of this recommendation suggests Representative Patman's personal distaste for the spectacle of a charitable institution which engages in bitter proxy fights. The recommendation should not, however, be rejected out of hand. Inasmuch as a proxy fight represents an aggressive expression of business judgment, the foundation is brought closer, for better or for worse, to active participation in the business.

Recommendation 5 would prohibit foundation or donor solicitation of contributions from suppliers or users. Since it is addressed broadly to what may be considered unethical methods of obtaining charitable contributions, the recommendation should be noted. But unless such contribution may inure to the benefit of the donor, or be to his business advantage, its solicitation from a supplier or user, though unethical, would seem to have no direct bearing on business competition.

IV. ADMINISTRATIVE SUPERVISION OVER FOUNDATIONS

Representative Patman frequently complains about the laxity of administrative supervision over foundation activities, particularly by the Internal Revenue Service.

Recommendation 17 states that: "Consideration should be given to a regulatory agency for the supervision of tax-exempt foundations." It is a mistake to blame the Internal Revenue Service for the doubts which are finding expression not only in this Report but, with increasing frequency, in the general news media concerning the activities of tax-exempt foundations and trusts. In response to Representative Patman's concern, the Service has, in fact, tightened its supervision over tax-exempt foundations and trusts. Form 990-A has been revised to expand the reporting requirements. These requirements now include data concerning salaries of officers; data on aggregate income accumulation, allocated between ordinary income and capital gains; and full data on corporate stocks held. The form must be filed in duplicate and is open to public inspection.⁴⁶ In a recent speech,⁴⁷ Commissioner Caplin explained a change in the pattern of audit in this field. He stated that the Service will no longer concentrate on the "most productive" situations—that is, those in which deficiencies seemed most likely—but rather will examine with more frequency areas which may produce no deficiencies.

⁴⁶ Treas. Reg. § 1.6033-1(a)(4) (1958), as amended, T.D. 6645, 1963-17 CUM. BULL. 10. See Proposed Treas. Reg. § 1.170-1, 27 Fed. Reg. 10489 (1962).

⁴⁷ Delivered Jan. 31, 1963, before the Foundation Luncheon Group, New York City.

It is not, however, on account of the readiness of the Service to intensify its supervision over tax-exempt foundations that we ought to refrain from blaming it for the supposed state of affairs. The supervision of tax-exempt foundations cannot be left to a revenue service alone. The function of a revenue service, after all, is to produce revenue. Revenue measures, it is true, are far from neutral on the subject of social or economic policy. It is, however, unrealistic and, if we may be so bold to say, unfair to look to the Revenue Service for a detailed implementation of such policies. Commissioner Caplin echoes this when he says, "the Internal Revenue Service is not the proper agency to exercise truly effective supervisory control."⁴⁸ If an existing tax arrangement produces the same return as might be produced by another arrangement arguably less objectionable on some point of economic or social policy, we cannot expect the Service to rise up in righteous wrath and seek to change the pattern—particularly when the tax legality of the present arrangement is not seriously in question.

Suppose, for example, that a business corporation wholly owned by a foundation pays rather large salaries to its officers and directors who also happen to be the foundation trustees, but that such salaries are not claimed as deductions on the corporate tax returns. Suppose that the business of the corporation has grown rather rapidly in the past several years and dividends have been very scant. It is not clear that, under these circumstances, the tax exemption of the foundation can be revoked. Certainly, if the salaries are not claimed as deductions there is no loss in tax collection at the corporate level. Similarly, the Revenue Service cannot be expected to police foundation speculation in the securities market or the policies which foundations employ in commercial lending of money.

We are convinced, however, that a proper approach to administrative supervision of foundations should begin at the state level. Charitable objects and purposes are traditionally a matter of state concern. Many of the alleged abuses of foundation and trust charitable giving have a local impact and are factually confined to the local setting. It would be unfortunate if these matters fell within the control and supervision of centralized federal agencies. No effort should be spared to examine and to improve, if need be, the existing machinery at the state level for supervision of foundation activities; otherwise Representative Patman's recommendation for creation of a supervisory federal commission to control the establishment and administration of foundations could become a reality.

⁴⁸ *Ibid.*

Indeed, continued abuses by foundations and, perhaps more significantly, continued public suspicion of their existence, if left unchecked or unallayed, may eventually result in drastic public action. This might lead to the liquidation of all existing foundations and the prohibition of their use under the proposition that all altruistic giving must be demonstrated and accomplished only by transfers made directly to public commissions or trusts⁴⁹ created by federal, state, and municipal branches of the government for general eleemosynary or public purposes, the only exception being private gifts to religious organizations and institutions. As Professor Sacks observed,⁵⁰ the issue of charitable giving is not an issue on which temperate, reasoned reactions have prevailed. Another serious crisis in the foundation field may move the public to destroy this form of charitable expression. We believe, therefore, that Representative Patman's Report should not be lightly, or conveniently, dismissed.

⁴⁹ A striking example of such a trust is to be found in the Board of City Trusts of the City of Philadelphia which has been in existence since 1869. The Board was established to take over the functions previously exercised by the City of Philadelphia. See PA. STAT. ANN. tit. 53, § 16365-70 (1957). The constitutionality of the act which created the Board was upheld in *Philadelphia v. Fox*, 64 Pa. 169 (1870), and it was this Board that was involved in the historic Girard trust litigation. See *Girard Will Case*, 386 Pa. 548, 127 A.2d 287 (1956), *rev'd per curiam*, 353 U.S. 230 (1957); *Girard College Trusteeship*, 391 Pa. 434, 138 A.2d 844, *cert. denied, appeal dismissed*, 357 U.S. 570 (1958).

⁵⁰ See Sacks, *Use and Misuse of the Private Foundation*, in NEW YORK UNIVERSITY FIFTH BIENNIAL CONFERENCE ON CHARITABLE FOUNDATIONS, PROCEEDINGS 203, 216-17 (1961).