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LEGISLATIVE PROPOSALS CONCERNING PRIVATE FOUNDATIONS†

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I. INTRODUCTION

In February of 1965 the Treasury Department, after more than a year of study, submitted its Report on Private Foundations[1] to the Congressional tax committees. Since that time Congress has not taken any substantial action[2] with respect to the recommendations contained therein. This inaction appears primarily attributable to the fact that the House Ways and Means and the Senate Finance committees have had to spend substantial amounts of time considering the use of the tax law as a weapon in the battle against inflation. Thus time which would have been available to study the proposals contained in the Report has been spent drafting the Tax Adjustment Act of 1966[2A] (which introduced graduated withholding and reinstated some of the excise taxes which were removed in 1965[2B]) and P.L. 89-800, which temporarily restricts the use of accelerated depreciation and suspends the investment credit.

While further consideration by the 89th Congress of the problems posed by the activities of some tax-exempt foundations[3] seems unlikely, it is probable that the 90th Congress will focus its attention on the ex-

† This article has been adopted from a paper presented by the writer at the Institute on Not-For-Profit Organizations sponsored by the Indiana State Bar Association at its Spring, 1966 meeting.

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1. Treasury Department Report on Private Foundations, printed by Senate Committee on Finance, February 2, 1965 (hereinafter referred to as Report).

2. The only overt action which Congress has taken with respect to the Report is to solicit public comments. These comments have been printed by the House Ways and Means Committee. *Written Statements by Interested Individuals and Organizations on Treasury Department Report on Private Foundations Issued February 2, 1965, Submitted to Committee on Ways and Means*, 89th Cong., 1st Sess., Volumes I and II (1965).

2A. 80 Stat. 38 (1966) (1966 U.S. CODE CONG. & AD. NEWS 546).

2B. Excise Tax Reduction Act of 1965, 79 Stat. 136 (1965) (1965 U.S. CODE CONG. & AD. NEWS 143).

3. Except as otherwise indicated, the term "foundation" means "private foundation."

empt organization area.[3A] Thus it is reasonable to assume that legislation designed to eliminate abuses in the private foundation area will be enacted in the foreseeable future.

In view of the likely congressional investigation of the foundation area, this is an appropriate time to consider the major problems which the Treasury feels should be examined, and in some cases reexamined. This article will also attempt to indicate the type of legislation which can be expected and the writer's views of the Treasury's proposals.

Since no drafts of the proposed legislation have been made public, the best barometer of probable changes in the foundation area is the Treasury Department's Report. While it would be naive to believe that the bill which will emerge from Congress will bear more than a slight resemblance to the proposals which the Treasury has made, the Report serves as an excellent starting point both in terms of the problems which exist and possible solutions.

Because of the importance of the Report as a basis for predicting future changes, it is useful to pause for a moment and examine both its background and general tenor.

With respect to the Report's background, it is significant that the Report was submitted in response to requests from the Ways and Means Committee of the House of Representatives and the Senate Committee on Finance for the Treasury to examine the activities of private foundations for possible tax abuses and to submit the Department's conclusions and recommendations. This is noteworthy for two reasons. First, it explains why the Treasury's recommendations are generally limited to transactions involving private foundations, even though several of the abuses which the Treasury has discovered may also take place when the charitable organization is publicly supported.[4] Second, and perhaps more important, it may well be that if Congress, after adopting remedial legis-

3A. In addition to legislation in the private foundation area, the 90th Congress will undoubtedly review the problems presented when a publicly supported exempt organization purchases investment assets with borrowed funds. In light of the Supreme Court's decision in Brown v. Commissioner, 380 U.S. 563 (1965), according capital gain to the transferor upon a bootstrap sale of a business to an exempt organization, it is probable that a substantially large number of these transactions will take place unless prompt congressional action is taken. Although two bills (H.R. 15942 and H.R. 15943, 89th Cong., 2d Sess.) were introduced in the 89th Congress to deal with this problem, and a public hearing was held on these bills, legislation to deal with broader problems of economic policy will probably prevent final action to be taken on this matter before 1967.

4. While the Report's scope is generally limited to problems involving private foundations, the Treasury has left the door open for Congress to adopt some of its proposals on an across the board basis. For example, the Report implies that the "abuses" present with respect to contributions of section 306 stock and contributions which may permit the donor to obtain a double benefit from his gift are equally present when the donee is a publicly supported institution. Report, p. 62, n. 5; p. 64, n. 10.

lation, believes that it has eliminated the private foundation abuses it may favor legislation which would treat contributions to foundations on a par with contributions to organizations such as the Red Cross and the United Fund. The Report, however, suggests that the provisions of existing law which treat contributions to publicly supported organizations more favorably than gifts to private foundations should be retained.[5]

The general tenor of the Report also serves as a barometer of future changes. By stating that private foundations are "uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly,"[6] the Treasury has made clear that it approves of the fundamental tax concessions made to private philanthrophy. Thus the contention of the "hawks" such as Congressman Patman that private foundations should be eliminated has been rejected. On the other hand, by proposing several measures designed to deal with the abuses which it has found, the Treasury has also rejected the views of the "doves" who feel that on the whole the private foundation area operates in a satisfactory manner and any change in the mechanics of existing law will cause more harm to charity than the benefit which society will receive by the elimination of abuses.

Instead of adopting either of these polar positions, the Treasury has adopted a middle of the road view—better known in this era of politics as one of consensus. The Treasury's proposals basically call for legislation tailored to deal with specific abuses. The elimination of the unintended benefits of existing law would not, it is felt, result in a decline in the level of benefits which the public receives from private philanthrophy. On the other hand, the removal of the abuses will remove the cloud of suspicion which presently lingers over private foundations as a result of congressional investigations. It is hoped that this will permit foundations to utilize their unique characteristics without fear of the need to justify their behavior to those who feel that the activities of private foundations should closely resemble the conservative practices of many publicly supported organizations.

While it is not inconceivable that the middle of the road approach suggested by the Treasury will be replaced by one of the more extreme proposals, such action seems unlikely. Therefore, future legislation in this area will probably take the form of proposals designed to deal with the specific problems which exist and not disturb the basic exemption of private foundations or the right to deduct most contributions to such organizations.

5. Report, p. 11.
6. Report, p. 5.

II. Self-Dealing

The first, and generally least controversial of the Treasury's proposals, deals with financial transactions between a foundation and persons who have made substantial contributions to it. Among the more typical of these transactions are loans by the foundation to the donor and purchases by the foundation of property owned by the donor, which he (the donor) wishes to convert into cash, but yet does not want to fall into the hands of unfriendly parties.

In order to understand the measure which the Treasury has proposed to deal with this problem it is helpful to briefly review the legislative history of this area.

Prior to 1950 there was no specific statutory language which was aimed at the self-dealing problem. As a result the only theory which the Internal Revenue Service could use to attack such transactions was that the foundation was not organized and operated exclusively for charitable purposes, as required by the statutory provision granting exempt status.[7]

However, there were two potential defects in this theory. First, it was possible for a court to find that the foundation was organized and operated exclusively for charitable *purposes* within the statute, even though some of its *activities* benefited a private party. Second, the opinions of some of the courts which considered the extent to which a foundation could operate a business without jeopardizing its exempt status raised some serious doubts as to whether the term "exclusively" as used in the predecessor of section 501(c)(3)[8] meant "solely" or whether it could be interpreted as meaning "primarily."

The defects which were present in the then existing law were recognized by the Congress in 1950. In that year the Ways and Means Committee of the House of Representatives recommended, and the House approved, legislation which would have generally prohibited all financial transactions between a foundation and its contributors, officers, or parties related to contributors or officers.

The Senate Finance Committee, while agreeing that abuses existed under the pre-1950 law, felt that the absolute prohibition upon self-dealing enacted by the House was too strict. Instead, it felt that charity

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7. The Revenue Act of 1894 [which was declared unconstitutional in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895)] required the organization to be "organized and conducted solely" for charitable, etc. purposes. Revenue Act of 1894, ch. 349, § 32, 28 Stat. 556. Subsequent legislation contained the "organized and operated exclusively" for charitable, etc., purposes test imposed by existing law. See Revenue Act of 1909, ch. 6, § 38 [1st], 36 Stat. 112; Revenue Act of 1913, ch. 16, § II (G)(a), 38 Stat. 172; Revenue Act of 1939, ch. 4, § 1004, 53 Stat. 146.

8. Int. Rev. Code of 1954, § 501(c)(3). Except as otherwise indicated, all subsequent statutory references are to the 1954 Code, as amended.

would not be harmed if these transactions were conducted on an arm's length basis. Therefore the Senate amended the House version of the bill by removing the absolute prohibitions and substituting an arm's length test—prohibiting only those transactions which did not meet an arm's length standard.

In addition, the Senate felt that the restrictions need not apply to transactions between a foundation and its officers, directors, etc. who did not contribute financially to the organization's support (or those related to the officers, directors, etc.).

It was the Senate version of the bill which emerged from Conference. Accordingly, present law,[9] which is a carryover from 1950, prohibits a foundation from entering the following transactions with a substantial donor (and certain related parties):

1. lending any part of its income or corpus without receipt of *adequate security* and a *reasonable rate of interest;*
2. paying any compensation *in excess of a reasonable allowance* for services actually rendered;
3. making any part of its services available on a *preferential basis;*
4. making any *substantial* purchase of securities or any other property for *more than adequate consideration* in money or money's worth;
5. selling any *substantial* part of its securities or other property for *less than adequate consideration* in money or money's worth; and
6. engaging in any other transaction which results in a *substantial diversion* of its income or corpus.

While tests which turn on standards of reasonableness and adequacy may seem proper from a conceptual viewpoint, the more than 15 years which have elapsed since the enactment of the 1950 legislation has indicated that there are four major problems in existing law.

First, the ability of a donor to enter into financial transactions with his private foundation opens the door to a host of transactions in which the donor may be able to obtain a subtle private advantage. For example, has not a foundation provided a private benefit to the donor by extending the maturity of his loan when it knows that requiring him to meet the terms of the original loan agreement would be financially embarrassing? Similarly, does not a donor have a special advantage by knowing that he can rely on his foundation as a source of capital for use in his

9. INT. REV. CODE OF 1954, § 503(c).

business? It is submitted that in both of these cases the donor receives a subtle and intangible benefit. However, assuming that the terms of the loan called for "adequate" security and a "reasonable" rate of interest, these loans would be permissible under existing law.

Second, the knowledge that its assets are subject to call by the donor in the future may have a detrimental effect upon a foundation's charitable activities. Unfortunately it is not possible to measure the extent to which the knowledge that their funds may be needed by donors in the future influences foundations to retain their corpus and sometimes their income, rather than distributing such funds to independent operating charities. However it does not strain one's imagination to foresee instances where the interests of charity would clash with the interests of the donor and the donor's views would prevail.

Third, even assuming that it were possible to administer the present arm's length standard in a manner which would eliminate all private advantage, the cost of such enforcement would be and is quite expensive. According to the figures stated in the Report, the annual cost of a single revenue agent assigned to audit self-dealing transactions, including both the agent's salary and the amount of additional revenue which would be generated if he were to devote his time to the examination of returns which are more productive of revenue, is in the neighborhood of $1/3 million.[10] While this is a high price for investigating transactions between a donor and his foundation, the cost to society of not insuring that funds which the donor has allegedly irrevocably devoted to charity do not in fact find their way back into the donor's pocket would be much higher.

Finally, the fact that a donor is permitted to engage in self-dealing transactions with his foundation is adversely affecting taxpayer morale. Under the general rules dealing with the deduction of charitable contributions a taxpayer, even though he may use the accrual method, may not deduct a charitable contribution until the contribution is actually paid. A promise to pay, even though enforceable under local law, is not sufficient to support a charitable contribution deduction.[11] This being so, it appears anamolous that a taxpayer can take an immediate deduction for a cash contribution to his foundation which is immediately followed by a withdrawal of the "contributed" funds in exchange for the donor's note. Transactions such as this add to the widespread belief that the tax laws are filled with loopholes for rich taxpayers who receive their income from property while those who must support their families by the sweat

10. Report, p. 18.
11. INT. REV. CODE OF 1954, § 170.

of their brows must bear a disproportionately high share of the cost of government.

Treasury Proposal

In an attempt to cure the defects noted above, the Treasury has recommended that the approach taken by the House of Representatives in 1950 be enacted into law. Under this approach there would be a general prohibition upon donor-foundation transactions. In addition, there would be a general prohibition upon financial transactions betweeen the foundation and certain other parties, such as the officers, directors and trustees of the foundation and parties who are related to either the donor or the officers, etc. Thus under the Treasury's proposals a donor or foundation officer would not be permitted to borrow funds from the foundation, irrespective of the "reasonableness" of interest and "adequacy" of security. Similarly, subject to the exceptions noted in the following paragraph, a donor or foundation officer would not be allowed to look to the foundation as a potential purchaser of assets he currently owns but wishes to convert into cash. This would be so whether the asset be a "white elephant" or securities traded on the New York Stock Exchange or whether the sales price be equal to, or less than, the property's fair market value.[12] As noted in the Report, this general prohibition on self-dealing is consistent with the common law disfavor of transactions between a trustee and the trust with respect to which he is acting as a fiduciary.

The four major exceptions to the prohibition upon self-dealing would be to allow the foundation to:

(1) pay salaries for services actually rendered to the foundation;
(2) purchase incidental supplies from the donor or business organizations with which he may be connected;
(3) permit the donor to lend funds to the foundation on an interest free basis; and
(4) permit the donor to purchase from the foundation certain assets which the other recommendations contained in the Report would require the foundation to dispose of.

Evaluation

In determining whether the Treasury's self-dealing proposal represents a desirable change in the law it is necessary to weigh the advantages

12. The Report discusses, and rejects, an exception to the general prohibition on self-dealing which would permit a foundation to purchase property from a donor where the market value can clearly be established and the purchase price is substantially less than such market value. Report, p. 22.

which would result from easily enforceable rules which could be applied uniformly to all private foundations against the problems which such a proposal may create. The proposal to outlaw all loans by a foundation to its donors is an excellent vehicle for making such a determination.

The often stated objection to this proposal is that it will apply to loans which provide a private advantage to the borrower as well as those which are arm's length in every sense of the term. While those who object to this proposal are not opposed to prohibiting loans which provide a special advantage to the donor-borrower, they object to the proposal on the grounds that it will prevent bona-fide arm's length loans and therefore will eliminate what has been a profitable method of providing funds for charity.

It is important to note that the arguments against the prohibition upon foundation-donor loans are based on the premise that it is easy to determine whether a particular loan does or does not provide the donor with a special advantage. However, as noted in the discussion of the problems created by existing law, the benefits which a borrower can obtain by borrowing from his foundation rather than from a bank are often so subtle that their detection is difficult or impossible. For example, how does one measure the advantage which a donor who has a ready source of capital which he can call upon for an immediate loan without any delay or embarrassing questions has over a party whose only source of additional capital is a bank?

However, even if one feels that the difficulty and expense of administering an arm's length standard is not sufficient to justify the general elimination of self-dealing, it should be enough to shift the burden of persuasion to foundations and their donors to show that the retention of the tests of reasonableness and adequacy are justified by a distinct advantage which self-dealing confers upon charity. In other words, in order to justify the diversion of the Internal Revenue Service's resources necessary to enforce a permissive statute, donors who wish to deal with their foundations should be required to prove not how the public benefits from self-dealing, but instead how charity will be hurt by this limitation upon their activities. It is only when the problem is looked at in this light that the situation is put in its true prospective.

I submit that the prohibition of self-dealing will not result in any over-all detriment to charity.[13] The self-dealing proposal does not outlaw

13. In some cases the prohibition on self-dealing will be detrimental to charity. For example, a donor will no longer be permitted to sell stock in a corporation which is listed on a national stock exchange to his foundation, even though the sales price is substantially lower than its quoted price. However, the loss to charity which may result from the elimination of these atypical transactions is the price which must be paid for

all lending of funds. The more typical type of loan—the purchase of bonds or other securities issued by unrelated corporations—is not restricted in any way. Thus if the loan to the donor was made on the same terms that the foundation would make loans to others it is likely that the foundation will be able to find borrowers other than the donor or his business. The same applies to the donor. If his loan were made on a truly arm's length standard he would be able to borrow the same amount on the same interest terms from an unrelated lending institution.

When viewed in this light it is obvious that if donor-foundation transactions were truly at arm's length neither the donor nor the foundation would be injured by a requirement that they must do business only with outsiders. When this is coupled with the advantages of removing any detrimental influence which self-dealing may have upon the foundation's charitable programs and eliminating an unadministerable test from the law, the recommendation clearly represents a desirable change in the law.

III. Delay in Benefit to Charity

The second of the major "abuses" which the Report addresses itself to is the delay in the application of tax-favored funds to charitable activities.

As the Report points out, the grant of an immediate deduction for charitable contributions is largely based upon the premise that the loss of tax revenue will be offset by the use of the contributed funds in a manner which will benefit the public, thereby decreasing the amount of governmental funds which will have to be expended for such purposes. This apparently works out satisfactorily in the case of operating foundations since these organizations generally use most of their contributions and income in their charitable programs on a current basis. Thus there is no significant lag between the loss of tax revenue and the offsetting public benefit.

On the other hand, contributions to a non-operating[14] foundation

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the introduction of a rule which will reduce the cost of administering existing law in the much more common situation in which it is difficult to determine whether a particular transaction provides a private advantage to the donor or subordinates the interest of charity.

Moreover, since the Report only deals with transactions involving private foundations, donors will be free to enter into "bargain sales" with publicly supported charities. Thus it seems likely that the enactment of the Treasury's self-dealing proposal will not reduce the benefit which charity in general obtains from these transactions. Instead, there will merely be a shift in the types of organizations to which these bargain sales will be made.

14. The Report suggests that the definition of a private operating foundation set forth in § 170(g)(2)(B) could be used to distinguish between operating and non-operating foundations for purposes of the proposals dealing with the elimination in the

are usually added to its corpus and only the investment income which the foundation receives is spent for charitable activities. The lag between the loss of tax revenue resulting from the allowance of a charitable contribution deduction and the offsetting benefit to charity does not appear to concern the Treasury. In fact, the Report rejects the suggestion made by Congressman Patman that the donor's deduction be delayed until his contribution is placed into the charitable stream.[15]

The Treasury's approval of the immediate deduction for gifts to non-operating foundations is obviously based on two assumptions. First, the addition of the foundation's endowment fund will be invested in income producing assets and therefore will increase the amount of income available for charitable activities. Second, the increased investment income will be used for charitable activities on a current basis. Since an immediate deduction for gifts to non-operating foundations is justified only if both of these assumptions are valid, the Report contains proposals intended to ensure that non-operating foundations (a) invest their endowment funds with a view towards generating current income and (b) expend that income on a current basis.

Taking these in reverse order, it is important to note that the retention of income can take one of two basic forms. First, a foundation can accumulate its investments income by leaving its dividends, interest, etc. in a checking account or by using the income to increase the size of its investment portfolio. The second, but less obvious, type of retention takes place when a foundation purchases property subject to a large mortgage and uses the income generated by the purchased property to meet the mortgage payments.[16] While the foundation winds up owning the property free from the mortgage, this is accomplished by diverting tax-exempt income from charitable activities to investment assets. Thus, as is the case when a foundation uses its dividend income to purchase additional securities for its investment portfolio, there is a substantial lag between the loss of tax revenue resulting from exempting the income generated by the

delay of the transmission of benefits to charity. Report, p. 23, n. 3. § 170(g)(2)(B) defines a private operating foundation as a privately supported organization which has substantially more than half of its assets devoted directly to, and expends substantially all of its income directly for, active charitable activities.

15. Report of Subcommittee No. 1, Select Committee on Small Business, House of Representatives, December 31, 1962 [hereinafter referred to as Patman Report—Installment No. 1], p. 133.

16. The classic example of this type of accumulation was presented in Shiffman, 32 T.C. 1073 (1950), where a foundation purchased property worth approximately $1.1 million for a $1,000 down payment and a mortgage for the balance. Although the foundation used the greater part of its income for the period before the debt was retired to meet the mortgage payments, the tax court held that this did not constitute a prohibited accumulation.

purchased property from taxation and an offsetting public benefit.

In order to deal with this problem, the Report contains a proposal, generally referred to as the "pay-out rule" which will require current distribution of investment income.

The problem of foundations investing their portfolios in a manner which minimizes current income is also the subject of a proposed statutory rule. Under this proposal, generally referred to as the "income equivalent rule," a non-operating foundation will be required to distribute a portion of its endowment fund if it invests a substantial portion of its corpus in assets which generate little or no current income.

Pay-Out Rule

As in the case of self-dealing, this area is best understood if the background of prior attempts to deal with accumulations of income are considered.

Prior to 1950 the only statutory tool which the Government had to deal with accumulations of income was the argument that the foundation was not organized and operated exclusively for charitable purposes. However, as was true in self-dealing, this did not prove to be an effective weapon.

The problems which the then existing law created were recognized by Congress in 1950. In that year the Ways and Means Committee approved, and the House adopted, rules intended to prevent the interposition of a foundation between the donor and publicly supported charities from unduly slowing the passage of funds into the charitable stream. Briefly, these rules would have taxed the income from rents, dividends, royalties, etc. (but not capital gains) which a foundation did not distribute for charitable purposes on a current basis.

There were, however, two major exceptions. The first would have allowed tax-free accumulations if such accumulations were placed into special 5-year trusts which specified the purpose for which the accumulated funds were to be used. This would have permitted accumulations in situations in which the foundation had a specific charitable project in mind, but would have eliminated accumulations for indefinite projects to be undertaken "sometime in the future."

A second exception would have allowed a foundation to accumulate, on a tax-free basis, an amount equal to one year's investment income. This would have allowed a foundation to provide for the possibility that it could not meet its commitments to a continuing charitable program if its investment income were to decline in a subsequent year.

The Senate did not agree with the approach taken by the House. It felt that while there were abuses under the then existing law, the rules adopted by the House were too mechanical and would result in the imposition of tax on legitimate accumulations. Instead of taxing accumulated income, the bill enacted by the Senate required foundations to publish information concerning their accumulations. The Senate hoped that making this information available to the public would channel requests for funds for charitable projects to foundations which had accumulated large amounts of income, thereby encouraging distributions.

The "publicity" provision adopted by the Senate was rejected in Conference. Instead, the present permissive rules were adopted as a compromise. These rules provide that exempt status shall be denied to an otherwise qualifying organization if its accumulated income is:

(1) *unreasonable* in amount or duration,
(2) used to a *substantial* degree for purposes other than those constituting the basis for the organization's exemption, or
(3) invested in such a manner as to jeopardize the carrying out of the function constituting the basis for the organization's exemption.[17]

The regulations which have been issued under these provisions generally exclude capital gains in determining whether a foundation has unreasonably accumulated its income.[18]

As in the case of self-dealing, the presence of tests which turn on substantialness and reasonableness are difficult and expensive to administer and lead to a lack of uniformity of application.

In order to eliminate the problems which are created by the presence of rules which are permissive in nature, the Treasury has proposed that legislation be enacted which would provide both taxpayers and the Internal Revenue Service with objective guidelines.

Under the Treasury's proposal a private non-operating[19] foundation would generally be required to expend the full amount of its current net income by the end of the year following the year in which the income is received. For example, a foundation which uses the calendar year as its accounting period would have to expend income received during calendar year 1966 by December 31, 1967. Thus a foundation would have between 12 and 24 months to decide how to spend its income.

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17. Section 504(a). Section 681(c) applies similar rules to non-exempt trusts which wish to obtain the unlimited deduction for charitable contribution provided for by § 642(c).
18. Treas. Reg. § 1.504-1 (1958); Treas. Reg. § 1.681(c)-1 (1957), as amended, T. D. 6605, 1962-2 CUM. BULL. 73.
19. Neither the required pay-out nor the income equivalent rule would apply to operating foundations.

For purposes of the pay-out rule, income would include investment income such as rents, interest, dividends and short term capital gains. Long term capital gains and contributions which the foundation receives would not be considered income for purposes of this rule and therefore would not have to be distributed on a current basis.

The purposes for which the income would have to be expended would be:

(1) contributions to publicly supported charitable organizations,
(2) contributions to privately supported operating foundations (but not privately supported non-operating foundations),
(3) direct expenditures for charitable programs which the foundation itself engages in, and
(4) purchases of assets which the foundation will use as part of its active charitable program.

In order to temper the mechanical operation of these rules, the Treasury has proposed the adoption of limited carryovers and carrybacks. These measures appear designed to permit a foundation to "average" the amount which it spends for charitable purposes and not require such an organization to tie the level of its charitable expenditures to the amount of investment income received in the current (and/or prior) year. Under these suggestions a foundation which wanted to accumulate its income for a reasonable period (the Report suggests 5 years, with extensions if the foundation shows "good cause") in order to make a "big splash" would be permitted to do so without penalty. However, income could only be accumulated for a specific charitable purpose which the foundation would have to identify at the time it began to accumulate its income.[20] A foundation would also be permitted to accumulate its income to restore prior invasions of corpus resulting from charitable ex-

20. The Report states that income could only be accumulated under this proposal if the purpose of the accumulation "requires accumulation by the foundation for its accomplishment, rather than, for example, by the intended charitable recipient." Report, p. 27. Presumably this means that a foundation which wanted to accumulate its income to establish an endowed chair at a designated university would not be able to take advantage of this proposal since the foundation's income could have been distributed to the university as earned, with instructions to retain the funds until the projected gift had been completed. In view of the liberal nature of the carryover, the exception seems curious and may be a trap for the unwary. While a well advised foundation would request Service clearance before it undertook such an accumulation, this exception seems sure to lead to controversy as to whether a contemplated accumulation had to be made by the foundation. It would appear that an accumulation to provide an endowed chair for a professor of law at a yet undetermined university would meet the requirements that the accumulation had to be made by the foundation. However, such a gift would raise the question of whether its purpose would be definite enough to satisfy the requirement that the foundation must be able to identify the charitable project at the time that it commences the accumulation.

penditures in excess of current income which had been made within a reasonable period (again the Report suggests 5 years) prior to the commencement of the accumulation. Thus there would be little reason, from a tax standpoint, for a foundation to feel that it had to refrain from undertaking a charitable project merely because the project would require financial support in excess of its current income.

Income Equivalent

Under existing law, when a foundation places substantially all of the contributions which it receives into its endowment fund, and then uses the endowment fund's income to purchase additional investment assets, there is a delay in the transmission to the public of benefits which should flow not only from the deduction granted with respect to the contribution, but also from the exemption of endowment income from taxation.

The required pay-out approach described above will, if enacted, adequately deal with the latter of these delays. However, the pay-out rule will not deal with the situation in which a foundation invests a substantial portion of its endowment fund in "growth" securities or other assets, such as unimproved land, which, although they may appreciate at rapid rates, do not produce any current income which the foundation can use to support current charitable programs. Thus unless other measures were taken, a foundation could postpone the time when the public would receive a benefit corresponding to the tax deduction allowed on the contributions which it received by investing its endowment fund in securities, such as Xerox stock, which pay only a minimal cash dividend. Moreover, since the required pay-out proposal excludes long term capital gain from the types of realized income which must be distributed on a current basis, and the gain which the foundation would realize upon the sale of assets such as Xerox stock would usually be long term capital gain, a foundation, through the purchase of low-yield, high-growth potential stocks could indefinitely postpone the day when the public could expect to benefit from the loss of tax revenue attributable to the exemption of a foundation's long term capital gains.

In order to discourage foundations from increasing the size of their investment portfolios (at the expense of slighting the immediate needs of charity) through the purchase of growth stock and other investments which generate little or no current income, the Treasury has proposed that when a non-operating foundation's income falls below what would be expected if it had its endowment fund invested in assets which are typically held by organizations such as colleges and universities, the foundation will be required to expend for charitable purposes the amount of current income which it would have received (and would have been required to expend) if it had its funds invested in the more traditional type of assets. The Treasury has suggested that the determination of the yield which would be applied in determining whether a foundation has invested its funds in assets which produce a reasonable amount of current income be left to regulations, but the Report suggested that a rate of 3-3½% would be appropriate at the current time.

The following examples illustrate the operation of the Treasury's proposals:

Example 1

Foundation A holds stock in Income Industries, Inc. (hereinafter referred to as "Income") with a market value of $100,000. Income regularly declares and pays cash dividends equal to 4% of the market value of its shares. Under the pay-out rule, Foundation A would have to expend $4,000, *i.e.*, an amount equal to its investment income. Since Foundation A realized more than the minimum level of income suggested in the Report,[21] no additional expenditures would be necessary.

Example 2

Foundation B holds stock in Growth Industries, Inc. (hereinafter referred to as "Growth") with a market value of $100,000. Growth regularly declares and pays cash dividends equal to 1% of the market value of its shares. Under the pay-out rule, Foundation B would have to expend $1,000, *i.e.*, an amount equal to its investment income. However, since its investment income was less than the minimum level suggested in the Report, an additional expenditure of $2,500 ($100,000 x 3½% = $3,500; $3,500 — $1,000 = $2,500) would be required. The additional expenditure could be made by distributing $2,500 worth of Growth stock to an acceptable organization. Alternatively, if Foundation B wanted to meet the income equivalent requirement by making cash contributions or by increasing the size of its charitable program, it could use cash gifts received from contributors or sell some of its endowment assets.

Example 3

Foundation C holds Income stock with a market value of $50,000 and Growth stock with a market value of $50,000. Foundation C's investment income would be $2,500, which would have to be expended under the pay-out rule. However, since Foundation C's total investment income

21. These examples assume an income equivalent rate of 3½%.

would be less than the amount which it would have received had it invested its funds in assets which are typically held by charitable organizations, Foundation C would have to make an additional expenditure of \$1,000 (\$100,000 x 3½% = \$3,500; \$3,500 — \$2,500 = \$1,000).

Evaluation

In valuing the Treasury's proposals dealing with direct and indirect income accumulations it is necessary to consider two basic questions. First, is it "fair" or "correct" for the Government to interfere with the judgment of foundation officers and trustees concerning such matters as the investment and distribution practices which the foundation should follow? Second, are the proposals made by the Treasury subject to reasonable administration, so as not to require foundations to keep voluminous records or raise the spectre of litigation whenever the officers decide to take any action which differs from the norm of foundation behavior?

With respect to the question of fairness, it is the writer's view that the two proposals, which are complementary in operation, are reasonable exercises of governmental regulation over organizations which largely owe their existence to the tax laws. The proposals neither dictate the policy which foundation officers must take with respect to particular investments nor the activities which they must finance. They only require that the foundation's endowment fund be invested in assets which generate a reasonable amount of current income and that this income must be distributed on a reasonably current basis. This really amounts to little more than a reminder to foundation officers that the tax favored treatment which is accorded foundations is based upon the assumption that the foundation will provide a current benefit to the public. It is proper for the laws which grant exempt status to foundations to contain reasonable rules to ensure that the basic purpose of the exemption is not subverted. The adoption of the Treasury's proposals would represent an improvement over present law and should be applied not only to organizations created in the future, but also to existing foundations.[22]

It is true, of course, that these proposals, especially the income equivalent rule, will generate difficult administrative problems. However, while these problems can not be overlooked, they should not be magni-

22. The Report suggests the adoption of a transition rule which would allow existing foundations a reasonable period in which to modify their investments to meet the income equivalent rule, without being required to distribute their corpus if their realized income fell below the applicable level. Report, p. 29. In addition, the Treasury has suggested that special rules may be needed to deal with existing organizations whose charters or articles of incorporation require accumulations of income or prohibit invasion of corpus. *Id.*, n. 10.

fied. Since the income equivalent will only be applied against a foundation's investment assets, it will not be necessary to value the assets which the foundation uses in its charitable program. Moreover, with respect to the valuation of investment assets, many of these assets will be susceptible to valuation by reference to stock market quotations which are available in a daily newspaper. With respect to those assets for which a market value is not readily ascertainable, the Treasury will use the value at the time that it was acquired by the foundation (the amount which the contributor claimed as a deduction with respect to property which the foundation acquired by gift), with periodic revaluations—the Treasury suggests 5 years—to deal with subsequent changes in value since the last valuation date.

While it is undoubtedly true that the addition of a rule which requires the valuation of investment assets will be more difficult to administer than a rule which merely requires the prompt distribution of realized income, the administrative problems which the two accumulation proposals taken together will raise will be substantially less than the problems which are encountered under the permissive language of existing law. Moreover, the adoption of objective standards will provide both Internal Revenue Service personnel and foundation officers with objective guidelines which can be relied upon to bring certainty to their actions.

IV. Business Involvement

There is no doubt that under existing law a foundation may engage in *some* unrelated business activity without jeopardizing its exempt status. However, determining the level of business activity which is consistent with the statutory requirement that a foundation must be organized and operated *exclusively* for charitable purposes is one of the most vexing problems facing the attorney who deals in the exempt organization area.[23] For example, while the so-called "organizational test" contained in the regulations[24] provides that a foundation's articles of organization may not authorize the officers to engage in an active business "[other] than as an *insubstantial* part of its activities," the so-called "operational test" allows a foundation to qualify for exemption "although it operates a trade or business as a *substantial* part of its activities, if the operation of such

23. Illustrative of the problems in the area is Rev. Rul. 64-182, 1964-1 (Part 1) Cum. Bull. 186, in which the Service held that an organization which received its income principally from the rental of space in a large commercial building which it owned and operated was exempt from where it was shown that its charitable program, which consisted of making gifts to other charitable organizations, was "commensurate in scope with its financial resources."

24. Treas. Reg. § 1.503(c)(3)-1 (1959), as amended, T.C. 6525, 1961-1 Cum. Bull. 186.

trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the *primary* purpose of carrying on an unrelated trade or business." (Emphasis added.)

The Report recommends that a foundation not be permitted to own, directly or indirectly, a 20% or larger interest in a business which, if operated directly by the foundation, would constitute an unrelated trade or business. Therefore, if the Treasury's proposal is adopted, the question as to how far a foundation may become directly involved in an unrelated business will be susceptible of an easy answer—not at all.

According to the Report, one of the advantages of a prohibition on business involvement would be the elimination of the competitive advantages which a business owned by a foundation has over privately owned commercial ventures. Thus the Treasury recognizes that the tax on unrelated business income,[25] which was enacted in 1950 to deal with the competitive advantages which exempt businesses had over those who had to pay a tax on their profits, is not fully effective.[26] In addition, the prohibition upon business involvement will reduce opportunities for subtle forms of self-dealing (such as having the foundation controlled business pay large salaries to the relatives of the donor). In the view of the Treasury the prohibition on business involvement will also ensure that foundation officers devote their entire efforts to the charitable activities of the foundation, rather than spending an undue amount of time with respect to the operation of a business, relegating charity to an afterthought.

In the writer's view, this proposal would represent a desirable change in the law. However, since the problems which it is designed to eliminate do not appear widespread, and will largely be eliminated by the proposals dealing with contributions of family corporation stock[27] and the broadening of foundation management,[28] it would seem likely that this proposal will be abandoned if substantial opposition is encountered.

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25. INT. REV. CODE OF 1954, § 511.

26. As the Report indicates, the tax on unrelated business income is deficient in that (a) it excludes certain types of organizations from its coverage and (b) a sophisticated tax planner can convert business income into a form which is specifically excluded from the tax on business income. The most usual manner of transforming business income into income which is excluded from the tax on unrelated business income is to have the foundation lease its business assets to a wholly owned subsidiary for a rental which will offset substantially all of the income which the assets generate. Although the operating company is not exempt, the rent which it has paid to its parent has been held to represent a deductible expense (at least if "reasonable") and therefore only a small amount of tax is imposed on the operating company. The rent received by the foundation is specifically excluded from the definition of unrelated business taxable income. INT. REV. CODE OF 1954, § 512(b)(3).

27. See text following note 29, *infra.*

28. See text following note 36, *infra.*

However, if the proposal dealing with direct business involvement is retained as part of the Treasury's proposals, additional thought should be given to the possibility that there may be some activities which a foundation should be permitted to operate, even though the income which the activity generates may be subject to the unrelated business income tax. One example of this (although not in the private foundation area) is advertising printed in the journals of such organizations as the American Medical Association. At the present time it is widely believed that the Treasury will issue regulations which will treat income from advertising printed in these journals as unrelated business income. Irrespective of the soundness of that decision, it seems unreasonable to require an organization to suspend the printing of such advertising. Therefore, consideration should be given to the possibility of developing an additional category of business activities, *e.g.*, semi-related business activities, the income from which would be subject to tax, but which an organization would be permitted to continue to operate.

V. Contributions of Property in Which Donor Has a Continuing Interest

The problem raised by contributions of property in which the donor retains a continuing interest can be illustrated by a gift of family corporation stock to a typical family foundation, *i.e.*, one whose officers are the donor, his wife, and his attorney. Typically the family corporation pays no dividends and the sole function of the foundation is to act as a conduit, *i.e.*, to receive additional cash contributions from the donor and distribute the additional contributions to the donor's church or alma mater.

Such an arrangement creates two problems. First, the donor is put in a position where his private interests may conflict with the interests of charity. For example, by all objective standards stock in the donor's family corporation usually does not represent an appropriate investment for charitable funds, both because of high risk and poor return. However, since the donor does not want the stock to fall into the hands of outsiders he generally will not, in his role as officer of the foundation, permit the foundation to sell the stock. Similarly, the donor, assuming that he is both a director of the corporation and an officer of the foundation, serves differing interests when he must help determine whether the corporation should pay a dividend or retain its earnings. While the interest of charity would be best served if dividends were paid, the private interest of the donor is often best served by having the corporation retain its earnings so that the amount representing the forebearance of dividends may be received tax-free upon his death. Human nature being what it is, it is undesirable to permit a donor to choose between benefiting himself or charity, especially where there is no effective manner of preventing the donor from exercising his discretion primarily by reference to the maxim "charity begins at home."

Second, and probably more important, a gift of family corporation stock is, in a realistic sense, little more than an incomplete gift. For example, assume that a donor owns 60% of the stock of Widget Corporation and contributes a 15% interest in Widget to his family foundation. Although the donor has parted with legal title to the 15% interest, the fact remains that after the gift he can continue to vote the entire 60% interest. Since the power to vote stock in a close corporation is probably the most important incident of ownership, the donor really has not parted with anything of value by transferring the stock to the foundation.

It is true, of course, that the donor has parted with the right to receive income on the 15% interest, as well as the right to receive 15% of Widget's assets upon liquidation of the corporation. However, while the donor has parted with the right to income and assets, the fact that the corporation will probably not pay any dividends—at least beyond the period necessary to establish a high value for the stock contributed to the foundation[29]—and the improbability of liquidation in the foreseeable future substantially diminishes (perhaps to zero) the value of the rights which the donor has given up. Thus it is no surprise that those who contribute family corporation stock to family foundations generally do not feel that their gifts have made them any poorer.

Likewise, charity gains very little from the receipt of family corporation stock. As already indicated, the value of such stock as an income producing asset—especially in situations in which the donor can siphon off virtually all the income in the form of salary, and what is left may be retained in the corporation if the donor exercises his voting rights for his self interest—is minimal. In addition, since it is contemplated that the foundation will retain the stock, the value of such stock cannot be used to finance a current charitable program. Thus until the sale of the stock or the liquidation of the corporation (neither of which is likely, at least in the foreseeable future) the contributed stock represents a dead asset in the foundation's hands.

29. The use of strategically timed dividends to enable the donor to establish a high value for the stock which he has contributed is illustrated by Pullman v. Commissioner, T.C. Memo Dec. 1964-218 in which a corporation controlled by the donor and his family had paid sufficient dividends to enable the class of stock which the donor had contributed to his foundation to generate income only during one year of the corporation's 19 year history. That dividend was paid in the year in which the donor had contributed a substantial amount of stock to the foundation.

In essence the situation is much the same as where the donor has made a pledge to a charity. In such a case, present law provides that even though the pledge may be enforceable under local law, the donor (even if he is an accrual basis taxpayer) is generally not permitted to claim a deduction upon making the pledge.[30] Instead, the deduction is deferred until the donor satisfies his obligation. The theory is that until such a pledge has been satisfied, the donor has not really parted with anything—even though his balance sheet may show less in the way of net assets—and charity has received nothing of sufficient value to justify allowing an immediate deduction.

As in the case of self-dealing and accumulations, the problems which are inherent in situations in which the donor contributes an interest in property in which he has retained a continuing interest were recognized and dealt with by the House of Representatives in 1950. In that year the House enacted legislation which would have had the effect of disallowing the deduction for family corporation stock if (a) the donor and members of his family had voting control of the foundation, and (b) the donor, his family and the foundation held 50% or more of the stock in the family corporation.

However, as in the case of the self-dealing and accumulation provisions, the Senate was less willing to adopt restrictive rules and refused to restrict deductions for family corporation stock. In the years that have elapsed since 1950 it is increasingly clear that gifts of family corporation stock really are no more complete than pledges. In fact, many of the publications which cater to estate planners and other tax consultants recognize this as a fact of life and advise their clients of the opportunity to create income tax deductions during life and to solve the liquidity problem which would otherwise arise upon death by making gifts of family corporation stock to family foundations. Thus it is no surprise to learn that the primary asset of a substantial number of foundations in the $100,000 to $1 million category is family corporation stock.

30. An accrual basis corporation is permitted to treat contributions made during the first 2½ months of its taxable year as made during the prior year if the contribution was authorized by the corporation's board of directors during the prior taxable year. INT. REV. CODE OF 1954, § 170(a) (2). While this permits a deduction for a year in which the corporation only made a pledge, the deduction is conditioned upon the satisfaction of the pledge within the permissible period. If the pledge is not satisfied no deduction is allowed.

However, in the case of estates and trusts, the deduction provided for by § 642(c), which is in lieu of the charitable contribution deduction allowed by § 170, is allowed if the amount which is to go to charity is permanently set aside on the trust's or estate's books. A current payment is not needed.

Treasury Proposal

The Treasury's proposed solution to this problem is to treat contributions of property with respect to which the donor or related parties maintain control as incomplete (and therefore not deductible) until (a) the foundation disposes of the property—such as by selling the stock or giving it to another charitable organization (other than a private foundation), (b) the foundation devotes the property to active charitable operations—such as converting land which the donor and foundation own jointly into a public park, or (c) the donor's (and related parties') control[31] over the business (or property) terminates.[32] At the time the foundation disposes of the stock or the donor and related parties terminate their control over the business (or property) the gift will be deemed to be complete and the donor will get his tax deduction.[33]

Evaluation

Because a substantial number of donors have discovered the benefits which can be obtained by making contributions of family corporation stock to a family foundation, it is likely that this proposal will meet with strong opposition—perhaps the strongest of all the proposals.

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31. The Treasury has suggested that control of an incorporated business be presumed to consist of ownership of 20% or more of the corporation's total combined voting power. The presumption, however, could be rebutted by showing that a particular interest did not constitute control. In determining whether the donor and related parties possess the requisite control, interests held by the foundation would be attributed to the donor and related parties until their individual interests in the corporation ceased. Similar rules are suggested with respect to other types of interests donated to the foundation with respect to which the donor retains a continuing interest. Report, p. 42.

32. Under the Treasury's proposal the gift would be considered incomplete for all purposes. Thus if the donor died before the foundation disposed of the stock (assuming that the donor and related parties continued to control the underlying corporation until the donor's death) the stock would be included in his gross estate. If the foundation disposed of the stock (or control of the business terminated) within 3 years following the donor's death an income tax deduction would be allowed for the donor's last taxable year and his estate would be allowed to claim a deduction to offset the inclusion of the stock in the donor's gross estate. However, if the foundation did not take appropriate action with respect to the stock within the 3 year period (assuming that parties related to the donor continued to control the underlying corporation) there would be neither an income tax nor an estate tax deduction.

Since the gift would be deemed incomplete until a qualifying event took place, no gift tax liability would arise even if the foundation continued to hold the stock and the donor and related parties retained control of the underlying corporation.

33. Although the Treasury recognizes that the use of gifts of family corporation stock create problems because of (a) the donor's conflict of interest and (b) the incomplete nature of the gift, the Report suggests that this proposal could be modified so as to postpone the donor's deduction only if the gift is made to a foundation over which the donor exercises substantial influence. Report, p. 43. The history of prior legislation in the foundation area, plus the appeal of the argument to the effect that if the unmodified proposal had been in the law it is doubtful if the large gift of Ford Corporation stock would have been made to the Ford Foundation, strongly indicates that the unmodified proposal will not receive more than cursory consideration by Congress.

Therefore the merits of this proposal will have to be carefully examined to determine whether the advantages which Government and charity will receive from its enactment outweigh the possible decrease in the amount of contributions which will be made if the tax deductions for this type of giving are restricted on a prospective basis.

The first factor which Congress will have to consider is whether the typical donor of family corporation stock who will be affected by the proposal will (a) continue to make such gifts on the assumption that he can "finalize" his gift at a later time, (b) make the same amount of total gifts, but change his pattern of giving and contribute either cash or property in which he does not retain a controlling interest, or (c) reduce his charitable contributions by an amount equal to the amount of his prior gifts of family corporation stock. This is a difficult question to answer, and it would appear that while there will not be any objective proof available to sustain either side, the donors have the stronger side of the argument. Therefore if the Treasury is to prevail it will have to show that even if the enactment of the proposal may result in a decrease in the amount of charitable gifts there are sufficient grounds to justify the enactment of the proposal.

There appear to be three grounds upon which the Treasury will have to base its case. First, because of the high risk, low dividends and lack of liquidity which characterizes family corporation stock, the retention of such stock is generally a poor investment for foundations. From this premise the Treasury will argue that unless there is some pressure on the donor to have his foundation dispose of the stock such stock, even though a poor investment, will be perpetually retained by the foundation. Therefore, one of the advantages of this proposal will be to force reinvestment of some of the assets of private foundations in publicly traded securities. As a corollary to the claim that the illiquid, high-risk, low-income characteristics of family corporation stock make such assets poor investments for charitable organizations, the Treasury will probably also contend that even if the adoption of the family corporation stock proposal were to result in a net decrease in the level of charitable contributions (because the decrease in the amount of gifts of family corporations stock to private foundations would not be fully offset by an increase in other types of charitable giving) the loss which society would suffer because of the smaller volume of gifts of such stock would be less than the cost of such gifts in terms of tax deductions claimed for gifts of this type.

Second, one of the areas in which taxpayers and the Internal Revenue Service constantly disagree is the value of shares in a closely held corporation. The adoption of the Treasury's proposal would, to a large extent, reduce the need to value such shares since the amount which the foundation realized upon the sale of the shares—which is one of the events which would permit the contribution to be deducted—would serve as the amount of the donor's deduction.

Third, the adoption of this proposal would go a long way towards restoring public confidence in private foundations which was destroyed by the Patman Reports. Many persons find it hard to understand why a person should be permitted to obtain a large charitable contribution merely by signing his name on the bottom of some papers prepared by his attorney, especially where he is no worse off after the transaction than before and charity is rarely any better off. To many, private foundations are just another of the many loopholes available to the wealthy. Thus adoption of the family corporation stock proposal will help remove private foundations from the "gimmick" status.

It seems doubtful that any one of the justifications for the proposal will, by itself, be sufficient to overcome the pressure which will be put on Congress to continue present treatment of gifts of family corporation stock. However, since this proposal is crucial to reform of the foundation area[34] the cumulative effect of the three justifications may be enough to attract enough congressional support for this proposal (at least in its modified form)[34A] to permit its enactment.

VI. Broadening of Foundation Management

Congressman Patman has suggested that all foundations be required to terminate their existence at the end of 25 years, distributing their corpus and accumulated income to other charitable organizations.[35] While Congressman Patman did not indicate those organizations which would constitute acceptable recipients of the required distributions, it seems probable that he would limit the ultimate donees to publicly supported charities.

The Treasury, however, does not agree that society would necessarily benefit from limiting a foundation's life. However, the Report indicates that with the passage of time, the interest of the donor may decline and the foundation may continue under the management of relatives of the donor who do not have the same intense concern for charity, but yet are unwilling to liquidate the foundation and turn its assets over to publicly supported charities. As a result, the Treasury predicts that unless cur-

34. In the writer's opinion the enactment of this proposal, coupled with the proposed self dealing rules, would eliminate most of the serious abuses in the foundation area.

34A. See note 33, *supra*.

35. Patman Report, Installment No. 1, p. 133.

rent measures are taken, the future will see a large number of foundations which merely collect dividends on the same securities contributed by the donor and distribute that income to the same organizations which the donor selected while he was a vital part of the foundation.

While this is not necessarily "bad," there is some question as to whether much of the benefit which society receives from organizations which exercise little or no independent judgment concerning the types of charitable activities which they should support is outweighed by other factors. At the end of 1962 there were approximately 15,000 private foundations, of which approximately 9,000 had total assets of less than \$100,000.[36] The great bulk of these small foundations will probably not receive substantial contributions in the future and therefore will continue to have relatively small endowment funds. Accordingly, unless some pressure is put on these foundations to distribute their corpus, their future activities will generally be limited to distributing modest amounts of investment income to those publicly supported organizations favored by their donors. However, despite their small size and semi-dormant nature, these organizations will have to be monitored by the Internal Revenue Service to determine whether they have lived within the statutory guidelines. This will require the Service to divert some of its resources from the examination of larger and newly created foundations, where the possibility of misuse of funds may be greater.

Moreover, from charity's viewpoint, little is gained from the proliferation of small foundations. The composite cost of legal and accounting fees, as well as other administrative costs, which are incurred by the large number of small foundations substantially decrease the amount of funds which will be available for charitable activities.

Although the Report recognizes these problems, it suggests that mandatory termination is not appropriate. Instead, it suggests that after a foundation has been in existence for a reasonable length of time persons unrelated to the donor should be required to make an independent appraisal and determine whether it would be best to (1) continue the existence of the foundation as an entity and maintain the same type of charitable activity, *e.g.*, to continue to make grants to the organization which the donor favored, (2) continue the existence of the foundation, but change the nature of the foundation's activities, or (3) terminate the foundation and make such distributions as they deem best.

In addition to reducing the proliferation of small, semi-dormant foundations, the Treasury feels that the introduction of some "new blood" to the governing board would largely prevent the adoption of a

36. Report, p. 77.

narrowness of attitude and a reluctance to modify foundation activities to reflect changes in society's needs. Thus the adoption of this proposal would help ensure that the great advantage of a private foundation, *i.e.*, its flexibility and imagination, will continue throughout its life.

Finally, the introduction of "outsiders" might make some of the "insiders" less willing to take improper liberties with the foundation's assets since to do so would expose the improper conduct to those who, at least theoretically, are not under their control and therefore who might object. Thus, the broadening of foundation management through the elimination of perpetual donor control would also decrease opportunities for abuse which cannot be adequately dealt with by legislation or administrative action.

To accomplish these goals the Treasury has suggested that after the passage of 25 years, the base of foundation management should be broadened so as to insure that "outsiders" (those other than the donor and parties related to the donor) make up at least 75% of the foundation's governing body. While this rule would apply to foundations presently in existence as well as those created in the future, foundations which have been in existence for 25 years or more would not be required to immediately diminish donor control. Instead, the Report suggests that such foundations be given 5 to 10 years in which to get outsiders to participate in their management.

VII. Marital Deduction Computation and Other Minor Problems

In addition to the major problems discussed above, the Report deals with several other less significant practices such as foundation borrowing,[37] foundation lending, trading and speculating by foundations, and the problems raised by contributions of certain types of assets, such as unproductive property, section 306 stock and other types of ordinary income assets. There is one additional "minor" problem, however, which merits special attention.

Because the federal estate tax is not fully integrated with either the gift or the income tax, some gifts are deemed sufficiently complete for the transfer to be subject to gift tax, but yet incomplete enough to require

37. While the Treasury combines foundation borrowing, foundation lending and speculating by foundations into a category labeled "financial transactions unrelated to charitable functions," which is discussed in the "major problems" section of the Report, the time and space limitations of this article do not permit more than passing reference to such transactions.

inclusion in the donor's taxable estate.[38] Similarly, some gifts are complete enough to allow the donor to shift income tax liability to either a trustee or beneficiary, but yet not sufficiently complete to escape inclusion in his gross estate.[39] This lack of integration generally works to the disadvantage of the donor.[40] However, the mechanics of the estate tax marital deduction permits gifts to foundations controlled by the donor to generate a substantial double benefit.

To illustrate the problem, assume that taxpayer X has assets worth $200,000 and wants to give $100,000 to his wife and $100,000 to charity.

If X were to make a testamentary gift of the $100,000 to charity (whether a publicly supported organization or a controlled private foundation), since the maximum marital deduction is equal to one-half of the decedent's adjusted gross estate[41] (which is determined before the deduction for charitable contributions), his taxable estate would be zero. (Adjusted gross estate of $200,000 less a marital deduction of $100,000 and a charitable contribution deduction of $100,000.) However, no charitable contribution deduction would be available to reduce X's income tax liability.

If X were to make an inter vivos gift of the $100,000 to either a publicly supported charity or a private foundation which he did not control, his taxable estate (before the exemption provided by section 2502) would be $50,000. (Adjusted gross estate of $100,000 less marital deduction of $50,000.) However, X would have been able to deduct the $100,000 gift to charity in the computation of his income tax liability and therefore would have substantially increased the amount of disposable income which he had available during his life.

Thus by making an outright gift to either a publicly supported charity or a private foundation over which he had no control, X could

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38. Although the question has not been litigated, it would appear that a gift from H to W which falls into the "estate trust" category (income to W for life, remainder to her estate) would be a taxable gift even though H, as sole trustee, retained the power to accumulate income. *Cf.* Treas. Reg. § 25.2511-2(d). If H could not exercise his power without the consent of W it is clear that his retained power would not preclude the transfer from being treated as a complete gift, and therefore taxable. Treas. Reg. § 25.2511-2(e). Under either alternative, the trust (including accumulated income) would be included in H's gross estate under the provisions of § 2036(a)(2). United States v. O'Malley, 383 U.S. 627, 86 Sup. Ct. 1123 (1966).

39. The power to accumulate income in the trust described in note 38, *supra,* whether exerciseable solely in H's discretion or only with the approval of the income beneficiary, would not require income generated by the trust's assets to be taxed to H. INT. REV. CODE OF 1954, § 674(b)(6)(A).

40. Although the gift tax credit provided by § 2012 is intended to prevent double taxation, in many cases the full gift tax paid upon the original transfer is not allowable as a credit.

41. INT. REV. CODE OF 1954, § 2056(c).

obtain an income tax deduction or an estate tax deduction, but not both.[42]

However, if X were to make an inter vivos contribution to a foundation with respect to which he exercised sufficient control to determine when and to whom his contribution would be distributed, the tax consequences would substantially change. It is clear that such retained powers would not preclude an immediate income tax deduction. But, as the Report indicates, the provisions of sections 2036 and 2038 would require the inclusion of the contribution, as well as any undistributed income[43] in X's gross estate. However, unlike the typical situation, the inclusion of the foundation's assets and income will accrue to the donor's benefit. For example, if X had made his contribution to a controlled foundation, irrespective of the fact that he had obtained the benefits of the income tax deduction in the year (or years) of the contribution to his foundation, his adjusted gross estate would be $200,000, but the marital deduction ($100,000) and charitable contribution deduction ($100,000) would result in a non-taxable return. Thus X is permitted to increase the amount which he can bequeath to his wife on a tax-free basis by an amount equal to 50% of the inter vivos gifts he made to his controlled foundation.[44]

It seems clear that this benefit, which arises out of the technical workings of the estate tax marital deduction, was never intended by Congress. Moreover, it cannot be justified by any overriding policy consideration. There is no reason why a gift to a controlled private foundation should provide the donor with greater estate tax benefits than gifts to publicly supported charities. In fact, the charitable contribution and exempt organization provisions indicate a desire by Congress to favor the latter type of organization.

The Report contains a proposal designed to eliminate this double benefit. The method which the Treasury has chosen is to eliminate from the donor's adjusted gross estate (and therefore from the base used to compute the maximum marital deduction) the value of property with respect to which the donor has obtained an income tax charitable contribution deduction. Thus where X made an inter vivos gift to a controlled foundation, the Report's proposal would result in an adjusted gross estate

42. It is true, of course, that the inter vivos gift provides the donor with an income tax deduction as well as an *exclusion* of the amount of the gift from the donor's gross estate. However as will be noted there is a substantial difference between the allowance of an estate tax deduction and the exclusion of the assets from the donor's gross estate.

43. United States v. O'Malley, *supra* note 38.

44. Technically, the additional amount which H could bequeath to W free from estate tax liability would be 50% of the inter vivos gifts to the controlled foundation plus accumulated income, valued at H's death.

of $100,000, thus limiting his marital deduction to $50,000. Since the value of the foundation's assets will not be included in X's estate, there will be no offsetting charitable contribution deduction available for estate tax purposes. Thus a donor to the controlled private foundation would be placed, in so far as the computation of his estate tax liability is concerned, in exactly the same position as if he had made a gift to a publicly supported charity.

Evaluation

This seems to be the simplest and neatest method of eliminating this unintended double benefit and no serious objection should arise. However, since Congress does not seem to be in any hurry to legislate in the foundation area, and it seems unlikely that the Treasury's proposals will be adopted on a retroactive basis, counsel may wish to consider whether the procedure outlined above would be of benefit to their clients.

VIII. SANCTIONS

The Report clearly explains the abuses present in the foundation area and the measures which the Treasury proposes to deal with these problems. However, with the exception of the proposals dealing with (a) contributions of property with respect to which the donor has retained a continuing interest, and (b) the estate tax marital deduction computation,[45] the only mention of the sanctions to be applied if the rules suggested by the Report are violated is a footnote[46] indicating that the sanctions of existing law would have to be carefully examined in order to determine whether they would be adequate enforcement tools.

The absence of suggested sanctions leaves one in the dark as to what action the Treasury thinks appropriate if a foundation lends money to its donor or does not distribute its invested income as contemplated by the proposed rules. Similarly, the Report offers no clue as to the sanction to be applied if a foundation does not appoint outsiders to its governing board after the suggested time period or purchases a larger than 20% interest in the stock of an active business corporation.

The first answer which comes to one's mind is that the foundation's exemption should be revoked. However, closer analysis makes it clear

45. The proposal dealing with contributions of property with respect to which a donor has retained a continuing interest contains a built-in enforcement measure. As noted *supra,* the sanction to be applied is to delay the donor's deduction until the gift is completed. The elimination of previously deducted charitable contributions from the donor's adjusted gross estate, which the Report proposes with respect to the marital deduction problem, is also tailored to the defect in existing law which it is intended to cure.

46. Report, p. 3, n. 9.

that revocation of exemption, which is the primary sanction under existing law,[47] is not desirable. For example, if a foundation lends funds to its donor, revocation of exempt status will subject the foundation's investment income to taxation, thereby irrevocably depriving charity of the funds which will have to be paid in taxes. In such a case, revocation will harm charity, which is an innocent party to the transaction, and will not penalize the "guilty" parties—the donor and the foundation officers who acquiesced to such a transaction.[48]

Similarly, depriving the foundation of exempt status if it distributes

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47. Under existing law a foundation's exemption may be revoked if it fails to meet the "organized and operated exclusively for charitable purposes" and other requirements imposed by § 501(c)(3); enters into a self-dealing transaction which does not meet the arm's length test of § 503(c); or accumulates its income or otherwise violates the rules of § 504.

Contributions to an organization made after publication of revocation of its exempt status in an Internal Revenue Bulletin (or after the effective date of revocation noted in the Bulletin) are not deductible. However, since the Commissioner has the power to challenge the foundation's exemption on a retroactive basis, some problems exist as to the deductibility of contributions for years in which the foundation is held to be non-exempt, but which were made prior to the date that the public was informed of the Service's determination. In order to be fair to persons who have relied upon the foundation's outstanding exemption ruling, the Service takes the position that contributions made to organizations previously held to be exempt will be deductible if the contribution is made before publication of revocation in the Internal Revenue Bulletin. Rev. Proc. 64-25, 1964-1 (Part 1) CUM. BULL. 694, 695. However, this liberal position does not apply where the contributor was in part responsible for the activities which gave rise to revocation or, at the time he made the contribution, the donor knew that the foundation's exemption had been revoked or was about to be revoked. *Ibid.* Since most donors to private foundations are officers of the foundation and therefore will have at least acquiesced to the improper conduct, and will certainly be in a position to fully be aware of tax difficulties which the foundation may be having, it would appear that few donors will be permitted to deduct contributions for years in which the Service successfully challenges the foundation's right to exempt status, even though the contributions may have been made before the Service initiated its investigation of the foundation's status.

Section 503(e) of the INT. REV. CODE OF 1954 contains special rules dealing with the deductibility of contributions to organizations which lose their exemption because of self-dealing transactions. Briefly, these rules provide that deductions will not be retroactively disallowed unless the donor (or a member of his family) was a party to the transaction and the transaction resulted in a substantial diversion. The regulations under § 503(e) also provide that if a contribution made in a year prior to the year in which the self-dealing transaction took place was made for the purpose of permitting the foundation to enter into the transaction resulting in loss of exemption, the pre-transaction contribution will also be disallowed. However, the difficulties of proving that a contribution made several years prior to the prohibited transaction was to permit the foundation to enter into such a transaction will necessitate the allowance of a deduction for virtually all pre-transaction contributions.

Finally, in the case of so-called "unlimited contributions" to private foundations, the donor will not be permitted to deduct his contribution if the donee foundation, within 3 years prior or subsequent to the contribution, enters into a transaction with the donor (or certain related parties) which violates the restrictive self-dealing rules of § 170(g).

48. It would appear that a foundation officer who knowingly permitted the foundation to enter into a transaction which resulted in the loss of its tax exemption, thereby decreasing the funds available to charity, could be surcharged if an action were brought by the attorney general of the state in which the foundation is organized. However, action along these lines has been, at best, negligible.

only one-third of its investment income would not be to the detriment of either the donor or the foundation's officers. As in the self-dealing situation, the only loser will be charity. A more desirable sanction (a) would only apply to the portion of income which the foundation did not distribute and (b) would not necessarily require that charity be foreclosed from receiving the funds which the foundation improperly accumulated.

The inadequacy of revocation as a sanction is also clear in the case of a violation of the proposed rules dealing with business involvement and broadening of foundation management. In either case it would seem futile to treat the foundation as a taxable entity. This is especially so in the case of a foundation which has used funds received as contributions to purchase more than 20% of the stock of a manufacturing corporation. In such a case, the foundation may be more than willing to surrender its exemption since it might then be able to go its own way without having to abide by the restriction that its income and assets must be devoted exclusively to charitable purposes.

One may attribute the Report's silence with respect to sanctions to the Treasury's belief that a discussion of proposed enforcement devices would divert too much attention from the Report's primary goal, *i.e.*, identifying existing abuses and suggesting measures to eliminate them. Thus the Treasury may have felt that the question of the penalties to be applied to the small percentage of foundations which refuse to follow the applicable rules should be postponed until after the congressional tax committees have reached at least a tentative decision as to what practices under existing law constitute "abuses" and what proposals should be adopted for their correction.

However, it seems more likely that the Report's silence on the question of enforcement devices is attributable to the inability of the Treasury to devise an appropriate set of penalties at the time the Report was published. By eliminating a detailed discussion of sanctions, the Treasury has given its staff additional time to design rules to encourage obedience to the proposed substantive provisions and penalize only those "guilty" parties who fail to follow the guidelines suggested in the Report.

Although more than a year has elapsed since the Report was published, there has been no public announcement indicating that the Treasury's study of the sanction problem has been completed. In fact, conversations which the writer has had with staff members of the Treasury's Office of Tax Legislative Counsel, which is the office which prepared the Report, have indicated that the sanction problem has not been fully solved and that the Treasury would appreciate receiving suggestions from private practitioners and members of the academic community who have had experience in this area.

In many ways the design of an appropriate set of enforcement devices is one of the more difficult problems presented by the quest for remedial legislation. Therefore the drafting of effective sanctions to deal with one or more of the major problems described above would not only provide genuine intellectual stimulation, but would also represent a substantial contribution to the development of the tax laws dealing with private foundations and other types of exempt organizations.

IX. Conclusion

In the writer's view, the Treasury's recommendations, if enacted, would eliminate the major abuses present under existing law without curtailing the benefits provided to society by private foundations. These proposals, which are obviously the product of careful study and deliberation, reflect a careful balancing of the underlying desire to foster private philanthropy through the tax laws and the legitimate federal concern that the interest of charity not be subverted. These recommendations would bring about a significant improvement in the present state of the law and therefore deserve careful consideration, both by Congress as a guide for future legislation, and by members of the bar as a barometer for predicting changes in the rules dealing with private foundations.