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Elaine Waterhouse Wilson

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**BETTER LATE THAN NEVER:
INCORPORATING LLCs INTO SECTION 4943**

*Elaine Waterhouse Wilson**

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Charitable enterprises deserve – indeed, they require – analysis, evaluation, planning; they are not matters to be lightly undertaken or perfunctorily carried on; they merit the genuine interest and undivided attention of the persons to whom society has entrusted their accomplishment. Consequently, the efforts of the speculator or the trader – whether successful or unsuccessful – are intrinsically inconsistent with the proper management of the affairs of a foundation.

– Report on Private Foundations,
Senate Finance Committee (1965)¹

I. INTRODUCTION

How much should charity and business intersect? Recent trends point toward a growing entanglement between the for-profit and nonprofit sectors. This trend is evident in the growth of social enterprise² and the advent of hybrid organizational forms designed to foster social enterprise, such as the L3C³ and the benefit corporation.⁴ A growing

1. STAFF OF S. COMM. ON FINANCE, 89TH CONG., TREASURY DEP'T REP. ON PRIVATE FOUNDS. 53 (Comm. Print 1965) (hereinafter 1965 REPORT).

2. The Social Enterprise Alliance defines “social enterprises” as “businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas.” *The Case for Social Enterprise Alliance*, SOC. ENTERPRISE ALLIANCE, <https://www.se-alliance.org/what-is-social-enterprise> (last visited Nov. 7, 2014). The Centre for Social Enterprise identifies a number of potential definitions of the term “social enterprise.” *What Is Social Enterprise?*, B.C. CTR. FOR SOC. ENTERPRISE, http://www.centreforsocialenterprise.com/C3_BC.html (last visited Nov. 7, 2014). In general, the term connotes a business enterprise that uses for-profit business methodologies to further a social purpose. The enterprise’s “[a]ssets and wealth are used to create community benefit” rather than being distributed to shareholders, and the enterprise is “accountable to both its members and a wider community” by maintaining a double-bottom line, producing healthy financial and social returns. John Thompson & Bob Doherty, *The Diverse World of Social Enterprise: A Collection of Social Enterprise Stories*, 33 INT’L J. OF SOC. ECON. 361, 362 (1974), available at <http://www.emeraldinsight.com/doi/full/10.1108/03068290610660643>.

3. Low-profit limited liability companies, or L3Cs, are a separate form of state law legal entity. Generally, an L3C is an LLC that is organized for a business purpose but is operated to accomplish one or more charitable purposes and would not have been formed but for those

number of business schools now teach social impact investing and venture philanthropy as part of their regular curriculum.⁵ Commentators ask whether charities should be run more like businesses⁶ and whether businesses should evaluate success on a bottom line that includes not only profit but charity.⁷ Some have gone as far as to suggest models for for-profit charity.⁸

Although it has received a great deal of press recently, the issue of the entanglement of business and charity is not new. In the early 1960s,

charitable purposes. In addition, no significant purpose of the L3C can be the production of income or appreciation of property, although it may, in fact, produce a profit or benefit from the appreciation of property. Finally, an L3C may not engage in political or lobbying activities. *See, e.g.,* VT. STAT. ANN. tit. 11, § 3001(27) (West, Westlaw through 2013-14 Vt. Gen. Assembly (2014)). In general, the L3C facilitates social enterprise by elevating charity as the primary (but not sole) purpose for the entity. L3C enabling statutes, such as Vermont's, were originally drafted with the intent to facilitate "program related investments" (as defined in Code Section 4944(c)) by private foundation investors. For a critique of L3Cs as vehicles for program related investments, see Cassady V. Brewer, *Seven Ways to Strengthen and Improve the L3C*, 25 REGENT U.L. REV. 329 (2012/2013).

4. Benefit corporations are another type of state law legal entity designed to facilitate social enterprise. Most benefit corporation legislation requires the entity to include a general charitable purpose as part of its corporate purposes, but that general charitable purpose need not be the primary, or even a significant, purpose for the organization. Typically, the traditional standard of care applicable to the board of directors of a business corporation is amended to provide that the board of the benefit corporation should take into account the effect of corporate actions on consumers, labor, the community and the environment. Unlike the L3C, there is no limitation on profit motive for a benefit corporation. For more information on benefit corporations, see J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certification and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012); J. Haskell Murray, *Corporate Forms of Social Enterprise: Comparing the State Statutes* (May 1, 2014) (unpublished chart), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988556.

5. *See* Nan Stone et al., *The MBA Drive for Social Value: Five Trends Boosting Social Benefit Content at U.S. Business Schools*, BRIDGESPAN GROUP (Apr. 14, 2009), <http://www.bridgespan.org/Publications-and-Tools/Career-Professional-Development/NonprofitCareers/The-MBA-Drive-for-Social-Value.aspx#.VF1P9odM5wy>. An informal review of Business Week's top 25 business schools indicates that 23 of the 25 had courses in social impact investing; the other two schools had significant offerings in the social enterprise field, so impact investing might be covered in other courses. *Id.*

6. *See, e.g.,* Charles R. Bronfman, Jeffrey R. Solomon & Michael Edwards, *Should Philanthropies Operate Like Businesses?*, WALL ST. J. (Nov. 28, 2011), <http://online.wsj.com/news/articles/SB10001424052970204554204577024313200627678>.

7. *See, e.g.,* Lori Kozlowski, *Impact Investing: The Power of Two Bottom Lines*, FORBES (Oct. 2, 2012), <http://www.forbes.com/sites/lorikozlowski/2012/10/02/impact-investing-the-power-of-two-bottom-lines/>.

8. Eric A. Posner & Anup Malani, *The Case for For-Profit Charities* (Univ. of Chi. Law and Econ., Olin Working Paper No. 304, 2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928976; but see, Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213 (2010); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819 (2012). *See also* Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387 (2014).

a subcommittee of the Select Committee on Small Business of the House of Representatives, led by Representative Wright Patman, held a series of hearings uncovering abuses in the private foundation sector and reviewing the impact of those abuses on the economy (the “Patman hearings”).⁹

Many of the abuses uncovered in the Patman hearings involved private foundation entanglement in operating businesses and related investment opportunities. A report later issued by the Senate Finance Committee in 1965 detailed a common tax planning strategy used by wealthy families.¹⁰ The family would transfer a controlling voting interest in the family business to a private foundation but retain the non-voting equity interests in the business that represented a significant portion of the value of the company. Generally, members of the family would control the voting interests by sitting on the governing body of the private foundation. This strategy preserved family control over the business, retained the vast majority of the value of the company in private hands, and generated a charitable income tax deduction, with estate and gift tax deductions to boot.¹¹ The family could then cause the private foundation to use its assets to make speculative investments,¹² to provide capital for related businesses through loans or equity investments,¹³ and to engage in anti-competitive behavior.¹⁴ The foundation’s governing body would focus primarily upon the maintenance and growth of these family business interests, at the expense of the charitable endeavors that formed the basis for the private

9. The results of the Patman hearings were published in three separate installments (the “Patman Reports”). CHAIRMAN’S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 87TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, FIRST INSTALLMENT (Comm. Print 1962) [hereinafter PATMAN REPORT or FIRST INSTALLMENT]; CHAIRMAN’S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, SECOND INSTALLMENT (Comm. Print 1963) [hereinafter PATMAN REPORT 2 or SECOND INSTALLMENT]; CHAIRMAN’S REPORT TO H. SELECT COMM. ON SMALL BUSINESS, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, THIRD INSTALLMENT (Comm. Print 1963) [hereinafter PATMAN REPORT 3 or THIRD INSTALLMENT]. Indeed, this discussion reaches even further back. For an excellent discussion of the history of private foundations in the United States, see Nina J. Crimm, *A Case Study of a Private Foundation’s Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093 (2001).

10. See 1965 REPORT, *supra* note 1, at 15-16.

11. *Id.* at 15-16.

12. *Id.* at 15.

13. *Id.*

14. *Id.* at 15-16.

foundation's tax-exempt status.¹⁵

The private foundation abuses detailed in the Patman hearings generated significant controversy and spurred Congress to curb the relationship between private foundations and affiliated businesses and families. In 1965, the Senate Finance Committee, based in part on upon the abuses uncovered in the Patman hearings, suggested a series of excise taxes¹⁶ that were designed to combat private foundation excesses.¹⁷ Many of these suggestions were passed into law,¹⁸ each of which was designed to combat a particular abuse detailed in the Patman hearings and later in the 1965 Report.¹⁹ In total, Congress enacted five penalty excise taxes,²⁰ which now form Chapter 42 of the Internal Revenue Code, known as the "private foundation excise tax rules."²¹ These excise taxes are designed to prohibit and penalize private foundation behaviors deemed by Congress to be undesirable.

Of the five excise taxes, Code Section 4943, the excess business holdings rule, was aimed specifically at curbing the entanglement of private foundations and related businesses.²² As described more fully in

15. *Id.*

16. Black's Law Dictionary defines an excise tax as "[a] tax imposed on the manufacture, sale, or use of goods (such as a cigarette tax), or on an occupation or activity (such as a license tax or an attorney occupation fee)." BLACK'S LAW DICTIONARY 15(c) (9th ed. 2009). West's Tax Law Dictionary takes a broader view, stating that the term "[m]ay be applied to most taxes except income tax or property tax. In general, the term means a tax on the manufacture, sale, or use of goods or with respect to an occupation or activity." ROBERT SELLERS SMITH & ADELE TURGEON SMITH, WEST'S TAX LAW DICTIONARY § E2030 (Westlaw 2015). In this particular case, it is a penalty in the form of an excise tax, which is designed to deter or punish a private foundation for an undesirable activity. *See generally* Nat'l Fed'n of Indep. Bus. v. Sebelius, 132 S. Ct. 2566 (U.S. 2012).

17. 1965 REPORT, *supra* note 1 at 26-30.

18. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

19. For a good discussion of the abuses identified by the Patman hearings and how the various excise taxes overlap in various ways to address these abuses, see Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59 (2004).

20. In addition to the Section 4943 excise tax on excess business holdings, the other four private foundation penalty excise taxes are as follows: (1) Section 4941 governs self-dealing transactions between a private foundation and certain disqualified persons; (2) Section 4942 prohibits a foundation from accumulating its income indefinitely by requiring the foundation to make minimum distributions for charitable purposes annually; (3) Section 4944 penalizes speculative investments that jeopardize a foundation's charitable purposes; and (4) Section 4945 taxes expenditures made for non-charitable purposes. In addition to the five penalty excise taxes, Congress also imposed an excise tax on the net investment income of a private foundation. *See* 26 U.S.C. § 4940 (2012). This investment income excise tax was not intended as a penalty, but as a mechanism for funding the enforcement of the other penalty excise taxes.

21. 26 U.S.C. § 42 (2012).

22. Except as otherwise noted, all references to the "Code" or to a "Section" mean the Internal Revenue Code of 1986, as from time to time amended.

Part III, Code Section 4943 limits a private foundation's ability to hold equity interests in those business entities that are also owned by individuals and entities affiliated with the foundation. The amount and nature of the equity interest that a foundation may hold in a business varies with the type of business entity. The statutory language of Code Section 4943 sets forth fairly detailed rules limiting the equity holdings of a private foundation in a business corporation.²³ It then provides only very general rules regarding a private foundation's holdings in unincorporated entities, such as trusts, partnerships, and sole proprietorships,²⁴ leaving Treasury to fill in the details by regulation.

The focus on corporate holdings in Code Section 4943 reflects the results of the Patman hearings and the 1965 Report, both of which detail myriad abuses involving foundation investment in business corporations. As detailed in Part II, virtually none of the testimony in the Patman hearings involved partnerships. As most of the perceived abuse uncovered by the Patman hearings was in the corporate sector, the dichotomy in statutory treatment between corporate ownership of an operating business and "direct" ownership of a business (including sole proprietorships, partnerships, fractional interests, and trusts) sufficed at the time for purposes of the statute.²⁵

Code Section 4943 addressed the business and investment world as Congress found it in 1969. Given the differential between corporate income tax rates and individual income tax rates at the time,²⁶ most businesses were set up as corporations. The income from a general partnership was passed through to the partners and taxed at the higher

23. 26 U.S.C. § 4943(c)(2) (2012).

24. *Id.* § 4943(c)(3). ("The permitted holdings of a private foundation in any business enterprise which is not incorporated shall be determined under regulations prescribed by the Secretary. Such regulations shall be consistent in principle with paragraphs (2) and (4), except that . . . [then setting forth general guidance for partnerships, sole proprietorships, and any other unincorporated entity]."). *See infra* Part III for more details regarding this provision.

25. As an example of the view that partnerships constituted "direct" ownership, see 1965 REPORT, *supra* note 1, at 7 ("Many private foundations have become deeply involved in the active conduct of business enterprises. Ordinarily, the involvement takes the form of ownership of a controlling interest in one or more corporations which operate businesses; occasionally, a foundation owns and operates a business directly."); *see also id.* at 30.

26. From 1954 to 1964 (during which the Patman hearings occurred), the maximum federal corporate tax rate was 52%, while the maximum individual rate was 91%. From 1965 to 1978, when the Chapter 42 excise taxes were passed, the maximum federal corporate rate was 48%, while the maximum individual rate was 70%. These rates began to drop over the next few years, although the maximum individual rate was still higher than the corporate rate. See the incredibly helpful chart of historical income tax rates in JEFFREY L. KWALL, THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS 6-7 (4th ed. 2012).

individual rates in effect at the time, and of course, the general partners had no liability protection. At the time, limited partnerships, the income from which was also passed through and taxed at the higher individual rates, sharply curtailed management participation by passive investors as the price to be paid for enhanced liability protection.²⁷ As a result, general and limited partnerships were used rarely at the time of the Patman hearings and primarily in specialized areas, such as real estate or oil and gas.²⁸ Foundation involvement with these relatively rare and generally small scale (at least comparatively) investment entities was not the source of abuse that Patman had targeted in his hearings—not when compared with the likes of the Rockefeller Foundation’s ownership and control of Standard Oil.²⁹

But then the world changed.

Wyoming passed the first limited liability company (“LLC”) statute in 1977,³⁰ throwing the tax world into disarray. The Code contemplated a business world with two primary business entities, corporations and partnerships. The LLC challenged that dichotomy: here was an entity with the liability protection of a corporation and the management flexibility of a partnership. With the Tax Reform Act of 1986, individual income tax rates fell below the combined corporate rate for the first time since the inception of the income tax,³¹ making the pass-through taxation of partnerships increasingly more attractive from an income tax perspective.³²

27. Historically, a limited partner was supposed to be a passive investor in the partnership. If a limited partner exercised too much control over the partnership, he could be deemed a general partner and lose the benefit of limited liability. At the time of the original passage of Chapter 42, most states would have been working under the original version of the Uniform Limited Partnership Act (“ULPA”), passed in 1916. UNIF. LTD. P’SHP ACT (1916). Later revisions of ULPA came in 1976 and in 1985, which loosened but did not abolish the limitations on limited partnership involvement in management. The 2001 revision to ULPA, however, did away with the control limitation; but that revision was well after both the 1986 re-codification of the Internal Revenue Code, which brought lower individual rates, and after the check-the-box rules of 1997. UNIF. LTD. P’SHP ACT (2001) (amended 2013). For further information on the limited partnership control rule, see Carter G. Bishop, *The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability As Well As Full General Partner Liability?*, 37 SUFFOLK U. L. REV. 667 (2004). See also LARRY E. RIBSTEIN, JEFFREY M. LIPSHAW, ELIZABETH S. MILLER & JOSHUA P. FERSHEE, UNINCORPORATED BUSINESS ENTITIES (5th ed. 2013).

28. Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1463-66, 1517-18 (1998).

29. See PATMAN REPORT, *supra* note 9, at v. See also 1965 REPORT, *supra* note 1, at 36.

30. Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577 (codified as amended at WYO. STAT. ANN. § 17-15-103 (repealed 2010)).

31. See Kwall, *supra* note 26.

32. Prior to 1986, corporate rates were generally lower than individual rates, and often

In 1986, however, it was not entirely clear that LLCs were entitled to this newly advantageous pass-through taxation regime.³³ Over time, the Code adapted to the existence of LLCs, primarily through the adoption of the “check-the-box” regulations effective January 1, 1997, which finally clearly allowed LLCs to take advantage of partnership tax structure.³⁴ Since that time, the LLC has, by and large, found its place in the Code.

Or has it? There are vestiges of the old tax world left, specifically including the private foundation excise tax on excess business holdings under Code Section 4943. To this day, the fundamental structure of Code Section 4943 remains virtually untouched.³⁵ The distinction between corporations and “direct ownership” entities, such as partnerships, remains, as does the deferral to Treasury to promulgate regulations on the application of Code Section 4943 to non-corporate entities. Neither the statute nor the regulations has been updated to take into account private foundation ownership of LLCs.

At the same time, the percentage allocation of private foundation endowments to alternative investments strategies has grown,³⁶ and LLCs

significantly so. *See id.* at 5 n.26. After the Tax Reform Act of 1986 and until 1993, individual rates were slightly lower than corporate rates (1987: 40% to 38.5%; 1988-1990: 34% to 28%; 1991-1992: 34% to 31%). *See id.* at 7. After 2003, the individual rates slightly exceeded the corporate rates once again. *See id.* This, of course, does not take into account the effects of alternative taxation regimes on dividends or capital gains.

33. *See* Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1199-1205 (1995).

34. *See* Susan Kalinka, *The Louisiana Limited Liability Company Law After “Check-the-Box,”* 57 LA. L. REV. 715, 719-20 (1995). For discussion on the check-the-box rule for entity classification, see *infra* Part III.E.1.

35. Congress has amended Code Section 4943, but not extensively. Code Section 4943 was amended as part of the Pension Protection Act of 2006, Pub. L. 109-280, 120 Stat. 780, to extend its application to supporting organizations and donor advised funds and to increase the amount of the tax. Earlier, there were corrections in 1969, 1976, 1980, 1984, most of which address grandfathering and correction.

36. The 2012 Council on Foundations–Commonfund Study of Investments for Private Foundations showed fairly strong returns for alternative investment strategies:

Within the broad category of alternative strategies, distressed debt returned 14.7 percent, followed by an 8.0 percent gain from marketable alternative strategies (hedge funds, absolute return, market neutral, long/short, 130/30, event driven and derivatives). Just 30 basis points behind at 7.7 percent was private equity (LBOs, mezzanine and M&A funds, and international private equity). Returns from other subcategories were private equity real estate (non-campus), at 6.7 percent; venture capital, at 6.5 percent; energy and natural resources, at 4.6 percent; and commodities and managed futures, at 1.3 percent.

Press Release, Commonfund Inst., Study Finds Private Foundations Rebuilding Assets After Recession Declines (Sept. 26, 2013), available at <https://www.commonfund.org/InvestorResources/CommonfundNews/Documents/2012%20CCSF%20Press%20Release%20-%20FINAL.pdf>. The collective allocation of the 140 participating foundations (representing \$78.7 billion in collective

have grown to be the primary choice of entity for many of these alternative investments.³⁷ In addition, single member LLCs are commonly used as a liability blocker for those activities that a private foundation does not wish to undertake directly.³⁸ Therefore, the lack of clarity in the treatment of LLCs under Code Section 4943 has grown to pose a significant practical problem for those private foundations³⁹ that oversee a diverse investment portfolio.

Updating a provision that governs a small segment of the tax-exempt organization world might not be at the top of Treasury's to-do list. That being said, changes in the investment world, the nonprofit sector, and the Code have brought new attention to Section 4943. Moreover, the fundamental question asked in the 1960s and answered in part by the passage of Code Section 4943—how much should the charitable sector and business world intersect?—is as relevant now as it was then. With the evolution of the investment theory and the renewed focus on the issue of the interaction between business and charity, finally addressing the manner in which LLCs are treated under Section 4943 is a change that is better late than never.

Part I of this Article traces the historical development of Code Section 4943 and the business entanglement issues that the Code Section was designed to combat. It then discusses developments in the law that occurred after the passage of Section 4943 that have implications for its structure, most importantly the introduction of the LLC. Part II describes the current statutory scheme of Section 4943, and the ambiguity in the manner in which it applies, and the practical problems and abuses that potentially arise from this ambiguity. In Part III, the Article reviews various options for clarifying the treatment of Section 4943 and evaluates them in light of the ongoing debate regarding the intersection of charity and business. This Article concludes, in Part IV, with a recommendation for change that provides administrative clarity and minimizes the possibility of abuse while allowing for modern investment

assets) to alternative strategies was 42%, down from 44% the prior year. This included an allocation across all institutions of 22% to private equity of all types and 39% to marketable alternative strategies, such as hedge funds. *Id.*

37. The LLC has been the primary entity of choice for new businesses since as early as 2004. See Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 *FORDHAM J. CORP. & FIN. L.* 459, 466-78 (2010).

38. The IRS recently confirmed that a donation directly to a single member LLC that is wholly owned by a private foundation or other eligible charity may qualify for a Section 170 income tax deduction. I.R.S. Notice 2012-52, 2012-35 I.R.B. 317.

39. With the passage of the Pension Protection Act of 2006, this problem now extends to donor advised funds and supporting organizations. 26 U.S.C. § 4943(e)-(f) (2012).

practices.

II. HISTORICAL BACKGROUND

A. *Brief History of the Private Foundation Excise Taxes*

1. Preliminary Discussions

Private foundations have been a part of American philanthropy in one form or another since roughly the turn of the century; criticism of the American private foundation has been around for about that long as well. The beginnings of the modern private foundation can be found in the efforts of turn-of-the-century industrialists such as Andrew Carnegie and John D. Rockefeller. Carnegie's endowment, the Carnegie Corporation, was founded in 1911, and the Rockefeller Foundation followed shortly thereafter in 1913.⁴⁰ It did not take long for the criticism to start—in 1913, President William Howard Taft established a commission (known as the Walsh Commission, after its chairman, Frank P. Walsh) to hold hearings on these newly formed vehicles for private philanthropy.⁴¹

The Walsh Commission eventually issued a report that roundly criticized private foundations as abusive and designed primarily to concentrate power and influence rather than further philanthropic goals.⁴² The report did suggest a number of restrictions on these private philanthropic entities, including limitations on investments and accumulations of income.⁴³

Congress did not adopt any of these changes; rather, they passed legislation authorizing the personal income tax deduction for charitable contributions in 1917 and extended the deduction to corporations in 1938.⁴⁴ It is likely not pure coincidence that the number of private foundations in existence grew dramatically immediately thereafter.⁴⁵ The ensuing rapid growth of business activity by private foundations did not go unnoticed, as the first version of the unrelated business income tax was passed in 1939.⁴⁶

40. Crimm, *supra* note 9, at 1103-04.

41. *Id.* at 1104.

42. *Id.* at 1105.

43. *Id.* at 1105; STAFF OF S. COMM. ON INDUS. RELATIONS, 64TH CONG., INDUSTRIAL RELATIONS: FINAL REPORT AND TESTIMONY SUBMITTED TO CONGRESS (Comm. Print 1916).

44. Crimm, *supra* note 9, at 1105, 1107.

45. *Id.* at 1107

46. *Id.*

President Harry S. Truman's tax message to Congress on January 23, 1950, criticized foundations as "a cloak for business ventures."⁴⁷ Later that year, Congress updated the unrelated business income tax, made an attempt at regulating self-dealing transactions, required additional public disclosure, and tried to prohibit excessive accumulations of income.⁴⁸ This set of reforms has been described by one commentator as "broader than it was deep" and "largely ineffective."⁴⁹ Most certainly, these reforms did not stem the tide of concern over the growing influence of private foundations.

2. The Patman Hearings

In 1961, Representative Wright Patman initiated a survey of 534 private foundations.⁵⁰ This study was adopted as a project of the Small Business Committee as part of the 87th Congress⁵¹ and formed the basis for what would become later become the Patman Report, a multi-volume report cataloguing myriad real and perceived private foundation abuses.

In the transmittal letter forwarding an interim report from his subcommittee to the full House Small Business Committee, Representative Patman noted that 111 of the 534 foundations "owned 10% or more of at least one class of stock in one or more of 264 different corporations" as of the end of 1960, including Ford, Eli Lilly, and Kellogg.⁵² After reciting this statistic, Patman stated, "[u]nquestionably, the economic life of our Nation has become so intertwined with foundations that unless something is done about it they will hold a dominant position in every phase of American life."⁵³ Patman went on to compare private foundations to the Standard Oil monopolies broken up by the Roosevelt administration, instituting the modern antitrust era.⁵⁴

In his transmittal letter, Representative Patman noted the significant

47. PATMAN REPORT, *supra* note 9, at 1.

48. Schmalbeck, *supra* note 19, at 60 n.4.

49. *Id.* In the 1965 Report, Treasury agreed, stating that the 1950 self-dealing rules provided "unsatisfactory results," and the 1950 rules on minimum distributions were "inadequate as well as difficult and expensive to administer." 1965 REPORT, *supra* note 1, at 17, 25.

50. PATMAN REPORT, *supra* note 9, at 2.

51. *Id.* at 1. The authorizing resolution was passed at the first meeting of the committee in 1962. See 108 CONG. RECORD 520 (1962).

52. PATMAN REPORT, *supra* note 9, at v.

53. *Id.*

54. *Id.* The transmittal letter specifically highlights the private foundations created by the Rockefeller family and the holdings of those different foundations in Standard Oil and related entities. *Id.*

amount of lost federal revenue attributable to the tax-exempt status of private foundations.⁵⁵ Patman argued that the lost tax revenues were not justified by the charitable use because the donor could

by a loan or exchange, secure a return of assets that have been donated should the occasion arise, that he can secure additional capital when needed, at 'reasonable' rates; that foundation funds have been used to help a donor when he found himself in a proxy fight; and foundation funds have been used to confer benefits on employees of companies, a substantial competitive advantage.⁵⁶

Many of these issues could be addressed—and were, in fact addressed—by the stricter regulation of related party transactions.⁵⁷ The Patman Report clearly discussed self-dealing transactions such as foundation lending, capital investments, use of foundation services on a preferable basis, and sales that were not at fair market value.⁵⁸

Even if such transactions had not occurred or had occurred on an arm's length basis, Representative Patman would still have been troubled. The interrelationship between a private foundation and business was, in and of itself, the issue. The Patman Report identified the use of private foundations to perpetuate and consolidate corporate control as a subject in need of "careful examination."⁵⁹ The report noted that foundation money and other assets were used to carry on proxy fights, citing specific examples that had occurred in 1960 and 1961.⁶⁰ In addition, the Patman Report expressed concern about the unfair

55. *Id.* at vi. For example, Gulf Oil created a foundation to hold 100% of the voting common stock of Pontiac Refining Corporation, then valued at \$32 million. In 1960, it had an income of \$750,000, of which \$380,000 was expended for tax-exempt purposes. *Id.*

56. *Id.*

57. Section 4941, passed in 1969 as part of the same set of private foundation excise taxes that included Section 4943, now prohibits all self-dealing transactions (subject to limited statutory exceptions), even if those transactions are fair and reasonable to the foundation and at fair market value. Prior to the enactment of Section 4941, then Section 162 of the Internal Revenue Code of 1954 loosely regulated these transactions by providing that a trust holding amounts for charitable purposes could not lend without "adequate security" and a "reasonable rate of interest"; pay "excess" compensation; make services available on a "preferential basis"; make "substantial purchases" of property for more than "adequate consideration"; sell "substantial" property for less than "adequate consideration"; or enter into any other transaction that would result in a "substantial diversion" of assets to the grantor, their family members, or certain controlled corporations. Revenue Act of 1950, Pub. L. No. 81-814, § 321, 64 Stat. 906, 954-56.

58. PATMAN REPORT, *supra* note 9, at 16.

59. *Id.*

60. *Id.* The First Installment of the Patman Report notes that the Albert A. List Foundation was involved in a fight for control of the Endicott Johnson Corporation in 1960. In addition, the Fred M. Kirby Foundation was involved in a control struggle over Alleghany Corporation in 1961. *Id.*

competition that can occur when an operating business is able to function in a tax-advantaged environment.⁶¹

Probably the most significant concern was the ability to run a corporation relatively unfettered by the needs of shareholders. This concern could not be addressed solely through the regulation of self-dealing transactions.⁶² If the governing body of a family foundation that owns the stock in the family corporation is largely comprised of individuals affiliated with the family corporation personally, there is little opportunity for independent oversight. The family foundation, as the sole or majority shareholder of the family company, was, as a practical matter, unlikely to pursue remedies for a breach of the fiduciary duties of its own board or the board of the controlled corporation. The general public, as the primary beneficiary of the charitable activities of the foundation, could generally only act through the various states' Attorneys General⁶³—again, not something that was likely to occur as a practical matter. As a result, the “[p]ossible conflict of interest between the duties of the foundation’s directors and trustees and their interest as officers, stockholders, and employees of business corporations whose stock is controlled by the foundation” would not necessarily be addressed by the regulation of self-dealing transactions as a matter of either state or federal law.⁶⁴

The Patman Report recommended an immediate moratorium on the recognition of additional tax-exempt foundations for a number of reasons, including the “rapidly increasing concentration of economic power in foundations” and the competitive advantages of foundation-controlled businesses over the small businessman.⁶⁵ Specifically, the Patman Report recommended that “[t]ax-exempt foundations should be prohibited from engaging in business directly or indirectly. Foundations controlling corporations engaged in business, through the extent of stock ownership in those corporations, should themselves be deemed to be

61. “A foundation-controlled business, with no stockholders to worry about could conceivably operate at a loss for some time in order to eliminate a competitor. It is suggested that in periods of recession destructive competition could result from foundation controlled enterprises since making a profit, paying dividends, and maintaining equity credit are of little concern to a privately controlled, tax-exempt foundation.” *Id.* at 15.

62. *Id.*

63. At common law, individual members of the general public do not have standing to enforce the public purpose of a charitable entity. *See generally* Iris Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093 (2005).

64. PATMAN REPORT, *supra* note 9, at 16. In the recitation of subjects in need of careful examination, the Patman Report extensively discusses corporation holdings but never specifically mentions the use of partnerships.

65. *Id.* at 1.

engaged in that business.”⁶⁶ Patman suggested limiting a foundation’s holdings to no more than three percent of the stock of a corporation, prohibiting a foundation from voting stock, and setting standards for foundation behavior in proxy fights.⁶⁷

The abuses discussed in the Patman Report occurred almost exclusively in the context of the foundation-controlled business corporations—there is almost never a discussion of partnerships as controlled entities.⁶⁸ Rather, partnerships were seen as an example of “direct” or “joint” ownership by a donor in his individual capacity. This lack of concern over the role of partnerships and similar entities is demonstrated by the data tables provided in the later installments of the Patman Report.⁶⁹ The Patman Report summarized the information that it gathered as it reviewed the 534 foundations it studied.⁷⁰ While the data is broken down to show detailed information about corporate holdings,⁷¹ there is no specific data regarding partnership holdings.

It is not even clear from the presentation of the schedules as to how partnership income or ownership is taken into account.⁷² Schedule 1 of the Patman Report broke down the gross receipts of the 534 foundations studied by the type of income. Partnership income might have been reported in the “other income” column, which may include partnership distributions, although pass-through items from partnership distributions of interest, dividends, rents and royalties, or gain and loss from property transactions also may be reported in those respective columns.⁷³

Similarly, Schedule 5 broke down the investments of the 534 foundations by asset type. Partnerships are not mentioned specifically—they might have been lumped with “other investments,”⁷⁴ or the schedule could have looked through the partnership entity and reported the underlying partnership assets in their appropriate columns on the rest of

66. *Id.* at 133.

67. *Id.*

68. By the author’s personal count, the word “partnership” was used no more than three times in the First Installment of the Patman Report. *See generally id.*

69. *See* PATMAN REPORT 2, *supra* note 9; PATMAN REPORT 3, *supra* note 9.

70. PATMAN REPORT, *supra* note 9, at v.

71. By way of example, Schedule 2 of the Patman Report sets forth “data regarding corporations in which certain foundations failed to report their ownership of 10 percent or more of each class of the corporation’s stock,” while Schedule 3 discusses “foundations’ ownership of 10 percent or more of any class of stock of any corporation.” Schedule 5, which details the asset holdings of the foundations in question, specifically breaks out corporate holdings at both book and market value. PATMAN REPORT, *supra* note 9, at 86-113.

72. *See generally id.* at 21-37.

73. *Id.*

74. *Id.* at 86-113.

the table. The note to Schedule 5, Column 8 does not even mention partnership interests, stating:

The foundation's assets consist of a variety of investments other than securities. Land, real estate, inventories, equipment, patents, insurance policies, works of art, etc. are examples of assets owned by foundations, and their market values may be considerably greater than the book values indicated by the foundation and used herein.⁷⁵

If we assume that partnership interests would have been reported as "other investments" on Schedule 5, a quick review of the reported numbers may indicate why partnership interests received little to no attention in the Patman Report. Of the 534 foundations studied, only 18 (and generally, only the very largest) had total "other investments" in excess of \$1,000,000 in book value.⁷⁶ By contrast, most of the foundations had corporate stock over \$1,000,000 in book value, and almost all had corporate stock with a fair market value of over \$1,000,000. By the numbers, the source of the problem was clearly with the corporate holdings of the foundations studied; partnership investments were an afterthought.⁷⁷

The Patman Report was published in three installments. The second installment, issued in 1963,⁷⁸ detailed the specific transactions of a handful of foundations: the Baird Foundations, the Hessie Smith Noyes Foundations, the Lawrence A. Wien Foundation, and the Harry B. Helmsley Foundation. Of the multiple transactions described in the second installment, only two sets of transactions involved a partnership.⁷⁹ In 1959, Lawrence A. Wien donated participating interests in five partnerships to his foundation. The report's objection to these donations does not appear to involve control or investment issues; rather, the concern was that Mr. Wien was able to shelter significant amounts of

75. *Id.* at 128 n.5.

76. *Id.* at 86-113. Schedule 5 states that, "[g]enerally, assets other than securities are shown at book value." *Id.* at 107.

77. One of the few mentions of partnerships comes in the recommendation section of the Patman Report in the context of the treatment of S Corporations:

In the case of corporations that are treated like partnerships (Subchapter S, Chapter 1, Internal Revenue Code), contributions to foundations should "pass through" to the stockholders and be included pro rata as contributions by the stockholders personally. In that way, the 20 percent and 30 percent limitations on contributions will be maintained. At present, through the mechanics of Subchapter S (Chapter 1, Internal Revenue Code), an extra 5 percent of the corporation's income becomes deductible by the stockholders.

PATMAN REPORT, *supra* note 9, at 134.

78. PATMAN REPORT 2, *supra* note 9.

79. *Id.* at 83-88.

capital gain through the donations.⁸⁰ Additionally, a partnership that owned a hotel and leased it to an operating company, which had been organized by and owned in part by Mr. Wein, made a series of donations to Mr. Wein's foundation. It does not appear that the Wein Foundation owned any part of the partnership; rather, the implication appears to be that Mr. Wein may have avoided receiving certain fees for legal services by having the partnership make donations to his foundation instead.⁸¹ In these few mentions of partnerships, the issue appears to be improper benefits accruing to the donor (capital gains avoidance or assignment of income) and not with the foundation's participation in the partnership itself.

3. The 1965 Treasury Report

In addition, the Senate Finance Committee and the House Ways and Means Committee asked the Department of Treasury to examine private foundation tax abuses and to report on its conclusions. On February 2, 1965, Treasury forwarded its report and recommendations for legislation to both Committees, which was then published by the Senate Finance Committee.⁸² While the 1965 Report built upon many of the abuses identified in the Patman hearings,⁸³ Treasury's study encompassed a wider universe of private foundations. According to the 1965 Report, Treasury "conducted a special canvass of approximately 1,300 selected foundations," more than double the amount studied by the Patman Report.⁸⁴

Like the Patman hearings before it, the 1965 Report highlighted a number of areas of private foundation abuse, including "Foundation Involvement in Business,"⁸⁵ "Family Use of Foundations to Control Corporate and Other Property,"⁸⁶ and "Financial Transactions Unrelated to Charitable Functions."⁸⁷

80. In each case, the partnership held a purchase money mortgage. They appear to be general partnerships (although this is not entirely clear). Mr. Wein donated two 50% interests, a 99.09% interest, a 20% interest, and a 2.5% interest. *Id.*

81. *Id.* at 81-82.

82. 1965 REPORT, *supra* note 1.

83. *Id.* at 2 n.5 (citing PATMAN REPORT, *supra* note 9; PATMAN REPORT 2, *supra* note 9; PATMAN REPORT 3, *supra* note 9).

84. *Id.* at 2.

85. *Id.* at 7.

86. *Id.* at 8.

87. *Id.* at 9. This portion of the discussion recommends a prohibition on borrowing, a limitation on foundation investments similar to the approved list approach used for private trusts at the time, and a prohibition on "trading activities and speculative practices." *Id.* This discussion

The discussion entitled “Foundation Involvement in Business” described Treasury’s recommendations that would eventually form the structure of Code Section 4943. Among the problems identified as resulting from foundation involvement in business enterprises were competition with for-profit enterprises, “opportunities and temptations for subtle and varied forms of self-dealing” that would be beyond the reach of what would become Code Section 4941,⁸⁸ and a diversion of management attention from charitable activities to commercial enterprises.⁸⁹ As a result, the 1965 Report proposed prohibiting foundation ownership “either directly or through stock holdings, 20 percent or more” of an unrelated business.⁹⁰

The 1965 Report catalogued the competitive advantages to a business arising out of the involvement of a related private foundation. There is, of course, the fact that the foundation is an income-tax-exempt entity. Beyond that, the 1965 Report noted that a foundation could essentially accumulate income within a controlled corporation.⁹¹ Even though Treasury simultaneously proposed a mandatory minimum distribution rule for foundation, the 1965 Report noted that those distributions would apply to the foundation’s income and not to the undistributed income of the controlled corporation.⁹² A decision to accumulate income within the business for its own capital needs (or simply so it does need to be distributed) runs counter to the need to fund charity currently. Similarly, a foundation, as shareholder, may be willing to continue to fund or to tolerate a business that is producing losses longer than for-profit shareholders or a third party lender might be willing to consider, at the ultimate expense of charity.⁹³

While the 1965 Report highlighted a number of abuses of business assets akin to subtle acts of self-dealing that might not be captured by what would become Code Section 4941, Treasury discussed at length another concern with foundation ownership of operating business interests. In the 1965 Report, Treasury set forth its rationale for why

would form the basis for current Code Section 4944 regarding jeopardizing investments.

88. *Id.* at 34 (“However broadly drawn the restrictions upon self-dealing may be, many of the conflicts of interest arising in this area are likely to be sufficiently obscure or sufficiently beyond the realms of reasonable definition to escape the practical impact of the limitations.”).

89. *Id.* at 7.

90. *Id.* It is unclear whether this 20% included holdings by affiliated persons at the date of publishing—it may not. *Id.*

91. The 1965 Report does not note that the accumulated earnings tax (currently found in Code Sections 531-537), would have worked to limit accumulations within a C Corporation to some degree. *See* 26 U.S.C. §§ 531-537 (1954).

92. 1965 REPORT, *supra* note 1, at 34.

93. *Id.* at 35.

private foundations should continue to be subsidized through tax-exemption and should not be subject to term limits.⁹⁴ Treasury believed that “the private foundation is uniquely qualified to provide a basis for individual experimentation and the exercise of creative imagination.”⁹⁵ The charitable activities of a private foundation are not limited in scope; it can fund whatever charitable projects may capture the interest of the foundation’s governing body. A private foundation is “easily established” and “inherently flexible.”⁹⁶ As such, it is particularly suited “for use by those who are concerned with, and devoted to the development of, new areas of social improvement.”⁹⁷ With the support of a private foundation, “[n]ew ventures can be assisted, new areas explored, new concepts developed, new causes advanced.”⁹⁸

Underlying this rationale for the preferential treatment of private foundation is the assumption that the foundation’s governing body is active and involved in setting and pursuing the foundation’s charitable mission. If, instead, the governing body is consumed by managing the foundation’s business holdings, then less time will be spent on the innovative programming that is the unique province of the private foundation.⁹⁹ “Business may become the end of the organization; charity, an insufficiently considered and mechanically accomplished afterthought.”¹⁰⁰

Treasury’s proposal to address the issue of foundation entanglement in commercial affairs at the expense of attention to charitable endeavors involved “an absolute limit on the involvement of private foundations in active business.”¹⁰¹ The proposal would prevent foundations from owning 20% or more of the combined voting power or the total equity of a corporation.¹⁰² Similarly, the 20% prohibition would apply to ownership “by a foundation, either directly or through a partnership, of a 20-percent or larger interest in the capital or profits of such a business.”¹⁰³ The 1965 Report’s proposal, however, did not attribute to

94. *Id.* at 31.

95. *Id.* at 35.

96. *Id.*

97. *Id.*; see also *id.* at 12-13 (private foundations “enrich and strengthen the pluralism of our social order” and “provided impetus for change within the structure of American philanthropy”).

98. *Id.* at 13.

99. See *id.* at 35 (“[t]he charitable pursuits that constitute the real reason for [a private foundation’s] existence may be submerged by the pressures and demand of the commercial enterprise”).

100. *Id.*

101. *Id.* at 36.

102. *Id.*

103. *Id.*

the foundation the ownership of interests held by donors, foundation managers, or their family members; rather, only interests held for the benefit of the foundation through trusts or other corporations would be attributed up to the foundation.¹⁰⁴

Interestingly, the retention of family control over business property was discussed separately from the issue of foundation involvement in commercial activities. The 1965 Report, after discussing the fact that donors often retain control of corporate holdings contributed to a private foundation, noted that “[s]imilar problems arise when a donor contributes an interest in an unincorporated business or an undivided interest in property, in which he or related parties continue to have substantial rights.”¹⁰⁵ Treasury expressed the concern that the private interests of the other equity holders of the business property would trump the interests of charity.¹⁰⁶ Treasury’s solution at the time was to propose that, if a donor and related parties retained control over contributed assets, the gift of the business was not yet complete and the charitable tax deductions associated with that contribution would be delayed.¹⁰⁷ For these purposes, control would be presumed if the donor and related party owned 20% of the voting interest in a corporation or a 20% interest in an unincorporated business or other property.¹⁰⁸ These provisions were not enacted in 1969 and have not been enacted to this day. Passive investing activities were excluded from the definition of “business,” as these activities would not have caused the diversion of attention away from charitable projects in the same manner as an active business might.¹⁰⁹

The 1965 Report also expressed significant concern over the possibility that family members may have conflicting fiduciary duties to the family company and the private foundation (not to mention personal interest), which may be too subtle to be captured by the self-dealing rules of Section 4941.¹¹⁰ Examples given in the 1965 Report include hiring decisions in favor of friends and family, decisions regarding

104. *Id.* As discussed *infra* Part III.B, when Code Section 4943 was eventually passed, it also attributed the holdings of donors, foundation managers, and their family members, as well as other related parties, to the foundation for purposes of calculating the 20% permitted holdings rule. 26 U.S.C. § 4946(a) (2012).

105. 1965 REPORT, *supra* note 1, at 8.

106. *Id.*

107. *See id.* at 41-45.

108. *Id.* at 42.

109. *Id.* at 36-37.

110. *See id.* at 40-41 (“Similarly, rules concrete enough to possess real efficacy in the prohibition of specific self-dealing practices cannot cope successfully and decisively with the subtle and continuing conflicts of interest which arise in the family stock situation.”).

accumulation of earnings and dividend policies, or liquidation of the foundation's interest in the business during difficult periods of time.¹¹¹ With regard to unincorporated interests, the Report states:

Problems of the same nature arise where the donor contributes to a private foundation an interest in an unincorporated business, or an undivided interest in property, in which he or those related to him retain substantial rights. Current tax deductions have been claimed, for example, for contributions of rights in the air space over the donor's, water rights adjacent to a private beach which the donor owns, or fractional interests in vacant land which the donor controls. Here again, because of the donor's close continuing connection with the property, it is hardly realistic to expect the foundation to make independent decisions about its use and disposition of the property.¹¹²

This assumes that the donor is a foundation manager and, therefore, owes fiduciary duties to both the foundation and the business entity owned by the foundation. In each case, it requires such individual to be in a position to control the activities of the business.

The emphasis on corporate abuses highlighted in the Patman hearings continued in the 1965 Report. In the section highlighting self-dealing abuses, Treasury gave 12 examples of problematic transactions¹¹³—ten of the 12 examples explicitly involve corporate holdings.¹¹⁴ The other two examples involve real estate that may have been owned directly by the foundation¹¹⁵—in neither case is ownership through a partnership specifically mentioned, although it is possible.¹¹⁶

As with the Patman Report, Treasury compiled statistics regarding the business holdings of the private foundations it reviewed. Of the approximately 1,300 foundations studied, approximately 180 reported ownership of 10% or more of one class of stock of a corporation.¹¹⁷ Of these, 109 owned 20% or more of a corporation and 40% held a 100%

111. *Id.*

112. *Id.* at 41. Again, the 1965 Report does not specifically mention partnerships.

113. *Id.* at 18-20.

114. *Id.*

115. *Id.* at 19-20. The two real estate examples are example 7 (real estate contributed to a foundation and leased back to the donor) and example 8 (foundation uses contributions to construct buildings leased back to the donors' retail businesses).

116. *Id.* Similarly, in the section discussing foundation involvement in business, Treasury provided six initial examples of significant business holdings by foundations—four of these addressed multiple corporate holdings, one was unclear, and the last involved the sale and lease back of the operating assets of 18 different businesses. Again, at no time does the 1965 Report indicate that any of these are owned by partnerships explicitly. *Id.* at 30-31.

117. *Id.* at 31.

interest.¹¹⁸ The 1965 Report further described its findings regarding foundation holdings in multiple corporations. It ended its description of its findings with the statement, “[i]n other cases, of course, foundations own and operate businesses directly,” with no further comment.¹¹⁹ All three examples of abuse in this area cited by the 1965 Report involved corporate holdings.¹²⁰

In summary, Treasury stated that its

recommendations seek not only to end *diversions, distractions, and abuses*, but to stimulate and foster the active pursuit of charitable ends which the tax laws seek to encourage. Any restraints which the proposal may impose on the flow of funds to private foundation will be far outweighed by the benefits which will accrue to charity from the removal of abuses and from the elimination of the shadow which the existence of abuse now casts upon the private foundation area.¹²¹

Thus, Code Section 4943 was originally designed not only to prevent subtle acts of self-dealing and abuse but also to insure that the foundation was appropriately focused on the charitable endeavors that justified its tax-exempt status. As with the Patman Report, however, the 1965 Report focused primarily on abuses involving corporate ownership and rarely discussed foundation ownership of affiliated partnerships.

4. Passage in 1969

The 1965 Report did not result in immediate legislation. The private foundation reform discussion continued through the late 1960s, culminating in the passage of the private foundation excise taxes (specifically including the excess business holdings tax) in 1969.¹²²

In 1969, Treasury forwarded to Congress a comprehensive tax reform package, which included proposals for the private foundation excise taxes.¹²³ Specifically referencing the 1965 Report,¹²⁴ Treasury stated that a minority of private foundations “are being operated so as to

118. *Id.*

119. *Id.*; see also *id.* at 30 ([o]rdinarily, the involvement takes the form of ownership of a controlling interest in one or more corporations that operate businesses; occasionally, a foundation owns and operates a business directly”).

120. *Id.* at 39.

121. *Id.* at 10 (emphasis added).

122. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

123. U.S. TREAS. DEPT., J. PUB. H. COMM. OF WAYS AND MEANS AND S. COMM. ON FIN., 91ST CONG., 1 TAX REFORM STUDIES AND PROPOSALS (Comm. Print 1969). Note the Tax Reform Proposal from Treasury appeared in multiple separate parts, which are referred to collectively herein as the “Tax Reform Proposal.”

124. *Id.* at 26.

bring private advantage to certain individuals, to delay passing on directly benefits to charity for extended periods of time, and to involve the foundation too greatly in the ownership and management of commercial enterprises.”¹²⁵ The Tax Reform Proposal cites involvement in commercial enterprises generally as the issue to be addressed and not simply involvement with businesses that are affiliated with the foundation and its foundation managers.¹²⁶ Treasury’s Tax Reform Proposal further states that the private foundation excise taxes were designed, in part, “to divorce the philanthropic aspects of foundations from their control and management of business.”¹²⁷

The portion of the Tax Reform Proposal that explains the private foundation excise taxes begins as follows:

Private philanthropy plays a special and vital role in our society. Beyond providing financial aid to areas which government cannot or should not advance (such as religion), private philanthropic organizations are uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.

Private foundations have an important part in this work. . . . [T]hey enable individuals or small groups to establish new charitable endeavors and to express their own beliefs, concerns, and experience. In doing so, they enrich the pluralism of our social order.¹²⁸

While the majority of private foundations were believed to be carrying out these charitable functions, a small number of foundations were operated “to bring private advantage to certain individuals” and “to cause competitive disadvantage between businesses operated by foundations and those operated by private individuals.”¹²⁹ As with the Patman hearings and the 1965 Report before it, the Tax Reform Proposal identified four primary issues to be addressed: (1) competitive disadvantage, (2) subtle forms of self-dealing, (3) deferral of benefits to charity through accumulations in controlled corporations, and (4) preoccupation by the foundation with business affairs.¹³⁰

The technical explanation of the provision that would become

125. *Id.*

126. *Id.*

127. *Id.* at 41.

128. U.S. TREAS. DEPT., J. PUBLICATION H. COMM. OF WAYS AND MEANS AND S. COMM. ON FIN., 91ST CONG., 1ST SESS., 3 TAX REFORM STUD. AND PROPOSALS 295 (Comm. Print 1969).

129. *Id.* at 295.

130. *Id.* at 296.

Section 4943 is entitled “Limitation on Involvement in Business.”¹³¹ The proposal would have prohibited a foundation from owning, directly or indirectly, 20% or more of the combined voting power or 20% or more of the equity of a corporation conducting an unrelated trade or business.¹³² This appears to be the first time that the issue of voting control versus economic interest is identified in the context of the structure of Section 4943.

With regard to partnerships, the Tax Reform Proposal does provide that “the direct or indirect ownership of a 20-percent or larger interest in the capital or profits of an unincorporated business not substantially related to the exempt functions of the owner foundation would also be prohibited.”¹³³ Other than this particular phrase, there is no separate discussion of partnerships.¹³⁴

5. Summary of Historical Materials

In summary, two things are clear from a review of the legislative materials that preceded the enactment of Section 4943. First, Treasury and Congress were concerned about private foundation involvement in business not only because of the potential for improper benefits to private individuals but also due to the potential for a private foundation to focus its attention on its operating business holdings at the expense of its charitable mission. These two concerns underscore Congress’ attempts to limit the ability of foundations to be involved in corporate activities through the ownership of voting stock. Second, almost all of the abuses highlighted in the legislative materials involved operating businesses held in corporate form—which, given the economic and tax structure in place at the time, made perfect sense. The almost non-existent discussion of business holdings in unincorporated enterprises in the legislative history, combined with the skeletal statutory provisions governing unincorporated enterprises, leads one to believe that the provisions that would address unincorporated entities—eventually enacted as Code Section 4943(c)(3)—were practically an afterthought.

131. *Id.* at 301.

132. *Id.*

133. *Id.* at 301-02. The Tax Reform Proposal also clarifies that the 20% limitation would apply to indirect as well as direct ownership, giving an example that would attribute stock held in trust to the foundation to the extent of its beneficial interest in the trust. *Id.*

134. As a further indication that Treasury was not focused on the issue of partnerships, the draft provisions that would define “disqualified person” under Code Section 4946 did not address partnerships. The proposed rules specifically addressed corporations, trusts (including grantor trusts), and estates but not partnerships or other unincorporated entities. *Id.* at 299.

B. *The Tax Code and LLCs*

The taxation of a business entity under the Internal Revenue Code is dictated by its classification as a partnership or an association under Code Section 7701.¹³⁵ Section 7701(a)(2) defines a partnership to include a joint venture or “other unincorporated organization, through or by means of which any business, financial operation or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation”¹³⁶ At the same time, Section 7701(a)(3) defines a corporation to include an association.¹³⁷ The question of whether an entity is a corporation or partnership seemed easy enough (usually) if the entity was, in fact, a corporation or a partnership under state law. The question was not so clear with the introduction of LLC statutes, which by definition were neither corporations nor partnerships.

When Wyoming introduced the first LLC statute in 1977,¹³⁸ the Code classified business entities as either associations or partnerships based on a multi-factor test.¹³⁹ The state law form of entity was not determinative for federal tax purposes,¹⁴⁰ although typically a state law corporation would be an association and a general partnership formed under the Uniform Partnership Act would be an unincorporated organization.¹⁴¹

Prior to 1998, in the event of ambiguity, the regulations under Section 7701 looked to see whether an entity had more of the characteristics of a corporation or of a partnership when assigning federal income tax classification. These factors were derived from a

135. 26 U.S.C. § 7701 (2012). *Compare* Treas. Reg. § 301.7701-1(b) (1977) (at the time LLCs come in) (“The Internal Revenue Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts.”) *with* Treas. Reg. § 301.7701-1(a) (as amended in 2014) (“The Internal Revenue Code prescribes the classification of various organizations for federal tax purposes. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.”).

136. 26 U.S.C. § 7701(a)(2).

137. *Id.* § 7701(a)(3). *See also* Treas. Reg. § 301.7701-2(c)(1) (2013) (“The term partnership means a business entity that is not a corporation under paragraph (b) of this section and that has at least two members.”).

138. *See* Wyoming Limited Liability Company Act, ch. 158, 1977 Wyo. Sess. Laws 577 (codified as amended at WYO. STAT. ANN. § 17-15-103 (repealed 2010)).

139. An entity could also have been a trust as defined under Treas. Reg. § 301.7701-4, although typically these are not business entities. *See* Treas. Reg. § 301.7701-1(b) (1977). *See also* Susan Pace Hamill, *The Story of LLCs: Combining the Best Features of a Flawed Business Tax Structure*, in BUS. TAX STORIES 295 (Steven A. Bank & Kirk J. Stark eds., 2005).

140. Treas. Reg. § 301.7701-1(c) (1977).

141. UNIF. P[’]SHIP ACT (amended 1997), 6 U.L.A. 5 (2001).

series of cases, most notably the *United States v. Kintner* case¹⁴²—as a result, the entity classification regulations under Section 7701 in existence prior to 1998 came to be known as the *Kintner* regulations. The *Kintner* regulations analyzed business entities for classification based on the following six characteristics:

1. Associates;
2. Objective to carry on a business and divide gains;
3. Continuity of life;
4. Centralized management;
5. Limited liability for entity debts; and
6. Free transferability of interests.¹⁴³

As both corporations and partnerships had, by definition, associates and an objective to carry on a business and divide the profits, these first two factors were generally not determinative for purposes of entity classification.¹⁴⁴ Rather, the last four factors—continuity of life, centralized management, limited liability, and transferability—were the keys to entity classification and were given equal weight.¹⁴⁵ If an entity had more “corporate” characteristics than “partnership” characteristics, then it would be deemed to be a corporation for tax purposes; otherwise, it would be a partnership.¹⁴⁶

The typical state law corporation has continuity of life of its own accord, while a general partnership technically dissolves on the withdrawal of a shareholder, among other things.¹⁴⁷ A corporation has exclusive centralized management through its board of directors,¹⁴⁸ while all general partners participate in management due to the agency relationship contemplated in the Uniform Partnership Act.¹⁴⁹ Of course, shareholders are insulated from liability for corporate debts while

142. *United States v. Kintner*, 216 F.2d 418 (9th Cir. 1954) (discussing a Montana medical practice formed as a partnership that liquidated and reformed as an unincorporated association in an attempt to obtain corporate tax classification).

143. Treas. Reg. § 301.7701-2(a)(1) (as amended in 1977).

144. *Id.* § 301.7701-2(a)(2); see also JAMES S. EUSTICE & THOMAS BRANTLEY, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 2.04 (Westlaw 2015).

145. *Larson v. Comm’r*, 66 T.C. 159, 172-84 (1976), *acq.* 1979-1 C.B. 1.

146. Treas. Reg. § 301.7701-2(a)(3) (as amended in 1977).

147. *Id.* § 301.7701-2(b)(1).

148. *Id.* § 301.7701-2(c).

149. *Id.* § 301.7701-2(c)(4).

general partners are personally liable for the debts of the partnership.¹⁵⁰ Finally, corporate shareholders can typically trade their shares freely absent a shareholder agreement to the contrary, while partnership interests are typically not transferrable without the consent of the non-transferring partners.¹⁵¹

This facts and circumstances test of the *Kintner* regulations was an administrative nightmare for the IRS and a source of both ambiguity and opportunity for taxpayers. A creative lawyer could attempt to draft a partnership agreement that had “corporate” characteristics.¹⁵² Even with creative drafting, an entity was always susceptible to entity classification review by the IRS—assuming, of course, the IRS had the resources to find and audit, on a case-by-case basis, all of the taxpayers utilizing creative drafting as a basis for entity classification.

In the face of this uncertainty, the Wyoming LLC was a statutory attempt to create the mythical hybrid entity that had corporate liability protection and federal partnership taxation without forcing lawyers to opt into the preferred tax classification through creative drafting.¹⁵³ Unfortunately, it took about a decade before the IRS confirmed that a Wyoming LLC governed by the default statutory rules would be taxed as a partnership. In the interim, Treasury unsuccessfully attempted to make limited liability the most important factor in the classification, thus making LLCs corporations by default.¹⁵⁴ Finally, in Revenue Ruling 88-76, the IRS ruled that a Wyoming LLC could qualify as a partnership for federal tax purposes under Section 7701.¹⁵⁵

In the interim, the uncertainty regarding the appropriate tax classification of LLCs chilled any movement to enact LLC legislation

150. *Id.* § 301.7701-2(d). Because the general partner in a limited partnership still has unlimited liability for partnership obligations, limited liability did not exist for a limited partnership unless the general partner had no substantial assets that could be reached by creditors (*i.e.*, it is an undercapitalized “dummy” acting as an agent of the limited partners.) *Id.* § 301.7701-2(d)(2).

151. *Id.* § 301.7701-2(e).

152. Thomas M. Hayes, *Checkmate, the Treasury Finally Surrenders: The Check-the-Box Treasury Regulations and Their Effect on Entity Classification*, 54 WASH. & LEE L. REV. 1147, 1156 (1997).

153. Hamill, *supra* note 139, at 296-97.

154. See 45 Fed. Reg. 75, 710 (Nov. 17, 1980) (codified at 26 C.F.R. pt. 301), *repealed by* Announcement 83-4, 1983-2 I.R.B. 30; see also Carter G. Bishop & Robert R. Keatinge, *An Introduction*, 42 SUFFOLK U. L. REV. 455, 455 (2009); Hamill, *supra* note 139, at 296.

155. Rev. Rul. 88-76, 1988 C.B. 360. The ruling held that the LLC had the corporate characteristic of a limited liability, but the terms of the Wyoming act ensured that the organization did not have free transferability or continuity of life. The organization in the ruling was a manager-managed LLC and therefore deemed to have the corporate characteristic of centralized management. Because the organization did not have a preponderance of corporate characteristics, it was taxed as a partnership. *Id.* (citing Treas. Reg. § 301.7701-2(a)(3) (as amended in 1983)).

nationwide. Between the passage in Wyoming in 1997 and Revenue Ruling 88-76, only Florida passed an LLC statute in 1982.¹⁵⁶ By 1998, there were only 26 active Wyoming LLCs.¹⁵⁷ With the issuance of Revenue Ruling 88-76, however, the floodgates opened. In 1991, Delaware adopted its LLC statute; by the end of 1996, all 51 U.S. jurisdictions had LLC enabling legislation.¹⁵⁸

Wyoming drafted its LLC statute to provide that any LLC formed under the laws of that state would have more partnership characteristics than corporate characteristics under the *Kintner* test, as the statutory rules for lack of transferability and continuity of life would always apply.¹⁵⁹ In Florida and other states that based their legislation on the Wyoming model, LLCs were also classified as partnerships, which was confirmed by the IRS in a series of formulaic revenue rulings addressed to each state statute.¹⁶⁰

On the other hand, some state statutes gave the LLC the flexibility to change the default rules that addressed the *Kintner* criteria. An LLC formed in one of these flexible states could essentially choose corporate or partnership status with careful drafting of its provisions regarding transferability and continuity of life.¹⁶¹ As a result, it was possible in these states to form LLCs that, “for non-tax purposes . . . in all meaningful respects . . . [were] virtually indistinguishable from closely held corporations, even though they could be structured to be taxed as partnerships.”¹⁶² The IRS approved the classification of LLCs structure in flexible jurisdictions as partnerships at the end of 1994.¹⁶³

This entity classification system structure ultimately proved unworkable. Each LLC classification determination was essentially a facts-and-circumstances analysis. With the proliferation of LLC enabling statutes, and therefore the proliferation of LLCs, after Revenue Rulings 88-76 and 95-10, the *Kintner* regulations were all but dead.

156. Fla. Ltd. Liab. Co. Act, 1982 Fla. Laws 82-177; *see also* Bishop & Keatinge, *supra* note 154, at 455; Hamill *supra* note 139, at 296.

157. RIBSTEIN, LIPSHAW, MILLER & FERSHEE, *supra* note 27, at 57.

158. *Id.* at 58; Hamill *supra* note 139, at 297.

159. RIBSTEIN, LIPSHAW, MILLER & FERSHEE, *supra* note 27, at 58; Hamill, *supra* note 139, at 297.

160. Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part One)*, 37 S.D. LAW. REV. 44, 45 n.7-8, 49 n.35, 50 (1992); Thomas Earl Geu, *Understanding the Limited Liability Company: A Basic Comparative Primer (Part Two)*, 37 S.D. LAW. REV. 467, 499 (1992).

161. Hamill, *supra* note 139, at 301.

162. PAUL R. MCDANIEL, MARTIN J. MCMAHON, JR. & DANIEL L. SIMMONS, *FEDERAL INCOME TAXATION OF PARTNERSHIPS AND S CORPORATIONS* 12 (5th ed. 2012).

163. *See* Rev. Rul. 95-10, 1995-1 C.B. 168; Hamill, *supra* note 139, at 302.

Ultimately, Treasury addressed the uncertainty caused by the *Kintner* regime through the implementation of the “check-the-box” regulations, which became effective as of January 1, 1997.¹⁶⁴ In summary, the check-the-box regulations set up default rules that initially classify an organization as either a corporation or a partnership. Some entities are allowed to elect a different classification than that assigned to them by default by checking the appropriate box on Form 8832—thus, the “check-the-box rules.”

If a business entity is not a trust or a disregarded entity,¹⁶⁵ then “a business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership.”¹⁶⁶ A business entity that is a corporation under state law, or that is an “association” as defined in Treasury Regulation Section 301.7701-3, will be treated as a corporation for federal tax purposes.¹⁶⁷ On the other hand, a partnership is a business entity that is not a corporation and has at least two members.¹⁶⁸

An eligible entity that is not deemed to be a trust or a corporation may “elect its classification for federal tax purposes.”¹⁶⁹ An unincorporated entity, such as an LLC, may elect to be treated as an association (and therefore, a corporation under Section 7701(a)(3)). If it does not elect association treatment, then a domestic unincorporated entity with two or more members is automatically deemed to be a partnership for federal tax purposes.¹⁷⁰

Under these regulations, the Code does not specifically recognize LLCs. Rather, a domestic LLC is treated as an unincorporated entity. Under the check-the-box regulations, an LLC is deemed to be a partnership for federal tax purposes by default and need do nothing

164. Treas. Reg. § 301.7701-1 – § 301.7701-3 (as amended by T.D. 8697, 1997).

165. Disregarded entities include single member LLCs, which are treated essentially as a sole proprietorship of the single member. Treas. Reg. § 301.7701-2(c)(2) (as amended in 2014).

166. *Id.* § 301.7701-2(a).

167. Treas. Reg. § 301.7701-3(a) (as amended in 2014). In addition, joint stock companies, insurance companies, state chartered banks that hold FDIC insured deposits, business entities owned by the government, and certain listed foreign entities are deemed to be corporations for federal tax purposes. *See* Treas. Reg. § 301.7701-2(b).

168. Treas. Reg. § 301.7701-2(c)(1).

169. Treas. Reg. § 301.7701-3(a). The election is made by selecting association treatment on Form 8832 (thus, “check the box”) and filing the form with the Internal Revenue Service. *Id.*

170. *Id.* § 301.7701-3(b)(1)(i). In contrast, a foreign unincorporated entity will be treated as an association by default if all of the members of the entity have limited liability. *Id.* § 301.7701-3(b)(2)(i)(B). A member of a foreign unincorporated entity is treated as having limited liability if “the member has no personal liability for the debts of or claims against the entity solely by reason of being a member” under the law of the country of organization. *Id.* § 301.7701-3(b)(2)(ii).

further if that classification is acceptable. However, an LLC may affirmatively “check the box” and elect to be treated as an association, and therefore a corporation, for federal tax purposes.

As a result, an LLC is the master of its own tax destiny. As the check-the-box election is purely mechanical, the LLC does not need to draft its way into corporate or partnership status, as it needed to do prior to 1997. Rather, the LLC can take full advantage of the flexibility afforded to it under state law for management, liability, and transferability purposes, while still being able to select between partnership or corporate tax classification.

The election to be treated as a corporation or a partnership is effective for “federal tax purposes.”¹⁷¹ There is no explicit statement in the Regulations that check-the-box applies for purposes of the private foundation excise taxes found in Chapter 42, including Section 4943.

III. CURRENT REGULATORY SCHEME

A. *Private Foundations, Defined*

Code Section 501(c)(3) exempts from federal income taxation entities that are organized and operated exclusively for religious, scientific, educational, literary, charitable, and other tax-exempt purposes.¹⁷² Organizations described in Code Section 501(c)(3) are further subdivided into two categories: private foundations and public charities.¹⁷³ A Section 501(c)(3) organization is deemed to be a private foundation unless it proves that it is entitled to public charity status.¹⁷⁴ There are, essentially, three ways for a Section 501(c)(3) organization to achieve public charity status:

1. Existing for a purpose that is deemed to be automatically worthy of public charity status. This category includes hospitals, schools, and churches¹⁷⁵ as well as organizations that perform testing for public safety,¹⁷⁶
2. Meeting one of two alternative mathematical tests, both of which are designed to measure the diversity of a charity’s financial

171. There are specific exceptions from the wholly owned entity rules for certain excise taxes (not Chapter 42) and for employment taxes. Treas. Reg. § 301.7701-2(c)(2)(v); Temp. Treas. Reg. § 301.7701-2T (as amended 2014).

172. 26 U.S.C. § 501(a) & (c)(3) (2012).

173. 26 U.S.C. § 509(a) (2012).

174. *Id.*

175. *Id.* § 509(a)(1) (via 26 U.S.C. § 170(b)(1)(A)(i)-(v) (2012)).

176. *Id.* § 509(a)(4).

support as a proxy for being responsive to the general public,¹⁷⁷ or

3. Qualifying as a “supporting organization”—that is, an organization that was created for the purpose of benefitting one or more other public charities.¹⁷⁸

If an organization does not fall into one of these categories, it is treated as a private foundation. The generic private foundation with which most people may be familiar holds a substantial endowment of investment assets that it obtained from a single person, family, or business, the income from which is used to make grants to other charities.¹⁷⁹

The consequences of being characterized as a private foundation rather than a public charity can be substantial.¹⁸⁰ One of the most serious of these consequences is that private foundations are subject to the Chapter 42 private foundation excise tax regime, including Code Section 4943.¹⁸¹ As currently enacted, Code Section 4943 imposes an excise tax on the “excess business holdings” of any private foundation in a “business enterprise.”¹⁸² The initial tax, on the foundation itself, equals 10% of the excess business holding.¹⁸³ However, if the excess holding is not corrected, the IRS may impose an additional excise tax of 200% of the excess holding.¹⁸⁴ Given these stakes, it is critical for a private foundation to understand what constitutes an “excess business holding” and a “business enterprise.” If either one of these elements is missing,

177. *Id.* § 509(a)(1) (via 26 U.S.C. § 170(b)(1)(A)(vi) and 26 U.S.C. § 509(a)(2)).

178. *Id.* § 509(a)(3) and § 509(f).

179. According to the Council on Foundations, in 2011 there were 73,764 private foundations with more than \$604 billion in assets and more than \$45 billion in annual giving. *Private Foundations*, COUNCIL ON FOUNDS., <http://www.cof.org/foundation-type/private-foundations> (last visited March 29, 2015). By way of example, the largest private foundation in the United States is the Bill & Melinda Gates Foundation, with an endowment in excess of \$37 billion according to its 2012 annual report. BILL & MELINDA GATES FOUNDATION, 2012 ANNUAL REPORT 4 (2012), available at <http://www.gatesfoundation.org/Who-We-Are/Resources-and-Media/Annual-Reports>.

180. Classification as a private foundation may also have a negative impact on a donor’s charitable income tax deduction under Section 170. Very generally, a donor’s income tax deduction is subject to a number of limitations, including an annual limitation in allowable deduction based on the donor’s modified adjusted gross income and a decrease in the amount of the charitable deduction for appreciated property. For gifts to a private foundation, a donor’s deduction may be limited to 20% of the donor’s adjusted gross income (as opposed to 50% or 30% for gifts to or for the use of a public charity), and the donor’s deduction may be limited to basis of certain types of appreciated property (as opposed to fair market value reduced by short term capital gain for gifts of appreciated property to a public charity.) *See generally* 26 U.S.C. § 170(b)(1)(D) & (e).

181. 26 U.S.C. § 4943 (2012).

182. *Id.* § 4943(a)(1).

183. *Id.* When originally passed in 1969, the rate was 5%; it was increased to 10% in 2006 as part of the Pension Protection Act of 2006, Pub. L. No. 109-280, §101(b), 120 Stat. 780.

184. 26 U.S.C. § 4943(b).

then the foundation is not liable for the Section 4943 excise tax.

If a business entity is not a “business enterprise,” then the excess business holding rules do not apply to the private foundation’s ownership of that entity.¹⁸⁵ The term “business enterprise” is defined in the negative, specifically excluding functionally related businesses (as defined in Code Section 4942(j)(4))¹⁸⁶ and any trade or business of which 95% of the income is passive.¹⁸⁷ As a result, a business enterprise generally means an unrelated, active trade or business, regardless of choice of state law entity.

The term “excess business holding” is defined with reference to the concept of a “permitted holding.” A permitted holding is the amount of an interest in a business enterprise that a private foundation may own without incurring the excise tax. By definition, then, an “excess business holding” is the amount of ownership in a business enterprise that exceeds permitted holdings.¹⁸⁸ The amount of a foundation’s permitted holdings depends upon two factors: the type of business enterprise and the holdings of certain individuals affiliated with the private foundation.¹⁸⁹ As a general rule, the foundation must aggregate its holdings in a business enterprise with the holdings of certain affiliated individuals and entities, known as “disqualified person,” in order to calculate its permitted holdings.¹⁹⁰ This prevents the foundation or its related parties from exerting control over the business enterprise through collective or indirect action.

From there, the definition of permitted holdings historically

185. *Id.* § 4943(d)(3).

186. A functionally related business is either (1) a trade or business that is not unrelated within the meaning of Code Section 513 or (2) “an activity which is carried on within a larger aggregate of similar activities . . . which is related . . . to the exempt purposes of the organization.” 26 U.S.C. § 4942(j)(4) (2012).

187. For these purposes, passive income is defined with reference to the unrelated business income tax sections of 26 U.S.C. § 512(b)(1), (2), (3), and (5) (2012), as well as the income from the sales of good that are not manufactured. *See* I.R.S. Priv. Ltr. Rul. 200517031 (Apr. 29, 2005) (no excess business holding in an LLC that only collected rents from the lease of land because the LLC was not a “business enterprise” within the meaning of Section 4943(d)(3)).

188. 26 U.S.C. § 4943(c)(1).

189. *Id.* § 4943(c)(2).

190. The term “disqualified persons” is defined in Section 4946(a)(1) as (1) substantial contributors, (2) foundation managers, (3) owners of 20% interests in certain business entities that are substantial contributors, (4) members of the family of any of the preceding categories, (5) a corporation, partnership, trust or estate in which the preceding categories of persons have a 35% beneficial interest, (6) certain governmental officials, and, (7) for purposes of Code Section 4943 only, certain affiliated private foundations. For purposes of ownership in a partnership under the 20% and 35% interest tests, Section 4946 looks to the profits interest in the partnership only. 26 U.S.C. § 4946 (2012).

depended upon the type of state law entity in which the business enterprise is formed. Consistent with the business entity dichotomy in the Code at the time of passage in 1969, Code Section 4943 contemplates two types of business entities: corporations and non-corporations.

B. *Permitted Holdings in a Corporation*

The statutory provisions determining a private foundation's permitted holdings in a corporation, found in Code Section 4943(c)(2), are fairly detailed. As a general rule, a private foundation may have permitted holdings in an incorporated business enterprise¹⁹¹ equal to 20% of the voting stock of the corporation, reduced by the percentage ownership of all disqualified persons.¹⁹² For example, if a corporation has issued and authorized 100 shares of only one class of voting stock, then the foundation and all its disqualified persons, collectively, may own only 20 shares of the corporation. If the foundation's disqualified persons already own 20 shares, the foundation would be allowed no permitted holdings in the corporation unless an exception applied (as discussed below).

There are a few exceptions to this general rule for corporations. First, a private foundation may own up to 2% of the voting stock and not more than 2% by value of all the outstanding shares of stock (voting and non-voting), even if 20% or more of the voting stock is held by disqualified persons.¹⁹³ Therefore, in the example above, even if the foundation's disqualified persons owned more than 20 shares of the stock of the corporation collectively, the foundation would still be allowed to own two shares of voting stock as permitted holdings.

Additionally, a private foundation and its disqualified persons may own up to 35% of the voting stock of the corporation if the foundation can establish, to the satisfaction of the Secretary of the Treasury, that effective control of the corporation rests with one or more individuals who are not disqualified persons.¹⁹⁴ For these purposes, the term "effective control" means "the possession, directly or indirectly, of the

191. The regulations provide that the term "incorporated business enterprise" specifically includes a real estate investment trust defined in 26 U.S.C. § 856 (2012). Treas. Reg. § 53.4943-3(b)(1) (as amended in 2009).

192. 26 U.S.C. § 4943(c)(2)(A).

193. *Id.* § 4943(c)(2)(C). For purposes of this *de minimis* rule, the holdings of various related private foundations are aggregated, so as to prevent a family from setting up multiple foundations and giving 2% of a business entity to each of them. *Id.*

194. *Id.* § 4943(c)(2)(B).

power to direct or cause the direction of the management and policies of the business enterprise, whether through the ownership of voting stock” or otherwise, such as voting trusts or contractual arrangements.¹⁹⁵ This typically occurs in the context of publicly traded companies where a family continues to retain a substantial block of shares in the company after a public offering.

Finally, a special rule applies if a private foundation owns shares in a corporation that has both voting and non-voting stock. Under Code Section 4943(c)(2)(A), if a private foundation and all of its disqualified persons do not own more than 20% (or 35%, if applicable) of the voting stock of a corporation, then the foundation may own an unlimited amount of non-voting stock.¹⁹⁶ In this manner, a family can give a significant amount of the business’s value to a private foundation, so long as the control of the business remains elsewhere. This exception makes sense in the context of the legislative history’s focus on the value of business control to a family and the potential for diversion from charitable purposes by attention to business matters. Traditional non-voting stock poses neither of these issues.

The concept of what constitutes “voting stock” becomes a key inquiry in determining a private foundation’s permitted holdings in a corporation. The Regulations provide that the term “voting stock” is “normally” determined by reference to the power to vote for directors, calculated without regard to treasury stock and authorized (but unissued) stock.¹⁹⁷ The Regulations specifically allow a corporation to “require the favorable vote of more than a majority of the directors, or of the outstanding voting stock” for extraordinary corporate actions, such as amendments to the organization’s articles of incorporation or bylaws.¹⁹⁸ Similarly, convertible or contingent stock will be treated as non-voting stock until the voting rights attributable to the stock actually vest.¹⁹⁹

C. Permitted Holdings in a Partnership or Joint Venture

In stark contrast to the statutory provisions regarding corporations, Code Section 4943(c)(3) does not contain significant detail with regard to the calculation of the permitted holdings of a private foundation in non-corporate entities.²⁰⁰ Rather, Code Section 4943(c)(3) provides that

195. Treas. Reg. § 53.4943-3(b)(2)(ii).

196. 26 U.S.C. § 4943(c)(2)(A) (flush language).

197. Treas. Reg. § 53.4943-3(b)(1)(ii).

198. *Id.*

199. *Id.* § 53.4943-3(b)(2).

200. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 201007062 (Nov. 25, 2009) (limited liability partnership

“the permitted holdings of a private foundation in any business enterprise which is not incorporated shall be determined under regulations prescribed by the Secretary.”²⁰¹ The statute then provides that the regulations be “consistent in principle”²⁰² with the corporate rules set forth in Section 4943(c)(2); special rules, however, apply for three different categories of entities: (1) partnerships and joint ventures,²⁰³ (2) sole proprietorships,²⁰⁴ and (3) “any other case.”²⁰⁵

When applying the principles of the corporate rules of Section 4943(c)(2) to partnerships and joint ventures, the statute provides that the term “profits interest” replaces “voting stock,” and “capital interest” replaces the term “nonvoting stock.”²⁰⁶ The Regulations provide that one should simply substitute this language when reading Treasury Regulation § 53.4943-3(b), which details the rules for corporate holdings under Code Section 4943(c)(2).²⁰⁷ Accordingly, if the foundation meets the 20% rule with regard to the profits interest in the partnership, then it appears that the foundation could hold an unlimited capital interest in the partnership.

Under the corporate rules, the calculation of permitted holdings focuses on voting control, which addresses Congress’ concern regarding the diversion of foundation attention away from charitable activities in favor of business interests. When applying these rules to partnerships, however, the calculation of permitted holdings is based on economic interest and not on voting control.²⁰⁸ Under the regulations, a private foundation’s interest in the profits of a partnership is determined “in the same manner as its distributive share” of partnership taxable income under Code Section 704(b).²⁰⁹ Code Section 704(b) governs the allocation of items of income and deduction among partners. In general, the terms of the partnership agreement govern the allocation of items of income or deduction, unless either the partnership agreement is silent or the terms of the partnership agreement do not have “substantial

analyzed under the partnership rules but applying the corporate 2% *de minimis* rule in Code Section 4943(c)(2)(C) as consistent in principle).

201. 26 U.S.C. § 4943(c)(3).

202. *Id.*

203. *See id.* § 4943(c)(3)(A).

204. *See id.* § 4943(c)(3)(B) (explicitly providing that a private foundation may not have any permitted holdings in a sole proprietorship).

205. *See id.* § 4943(c)(3)(C) (2012).

206. *Id.* § 4943(c)(3)(A).

207. Treas. Reg. § 53.4943-3(c)(2) (as amended in 2009).

208. *Id.*

209. *Id.*

economic effect.”²¹⁰ When the partnership agreement is silent, a partner’s share of items of income or deduction will be allocated in accordance with a partner’s interest in the partnership.²¹¹

Unfortunately, there is no generally applicable definition in the Internal Revenue Code of a partner’s capital interest in a partnership.²¹² For purposes of Section 4943, a private foundation’s capital interest is determined first with reference to the applicable provisions of the partnership agreement. In the absence of a partnership agreement provision, a foundation’s partnership interest for purposes of Section 4943 is the greater of its interest upon withdrawal from the partnership or upon liquidation of the partnership.²¹³

In a similar context, the family limited partnership rules set forth the definition of a capital interest in a partnership in which capital is a material income-producing factor for purposes of Section 704(e).²¹⁴ Under these rules, the recipient of a capital interest by gift or by purchase in a capital-intensive partnership will be recognized as a partner if the transaction is bona fide.²¹⁵ If, however, the donor retains control over the transferred interest, directly or indirectly, then the donor will continue to be treated as the owner of the interest for tax purposes.²¹⁶ For purposes of Section 704(e), a partner’s capital interest

210. 26 U.S.C. § 704(b)(2) (2012).

211. *Id.* § 704(b)(1).

212. Sheldon I. Banoff, *Identifying Partners’ Interests in Profits and Capital: Uncertainties, Opportunities and Traps*, TAXES—THE TAX MAG., Mar. 2007, at 223 (stating that “neither the Code nor regulations set forth a comprehensive definition of” a partner’s interest in partnership capital).

213. Treas. Reg. § 53.4943-3(c)(2).

214. Treas. Reg. § 1.704-1(e)(1)(ii) (as amended 2013) (“a person shall be recognized as a partner for income tax purposes if he owns a capital interest in such partnership whether or not such interest is derived by purchase or gift from any other person”); Banoff, *supra* note 212, at 223.

215. Treas. Reg. § 1.704-1(e)(1)(iii).

216. A transfer of a capital interest to a family limited partnership may, however, be treated as a “mere sham for tax avoidance or evasion purposes” if the donor remains the real owner of the interest through the retention of dominion and control over the capital interest that he purported to transfer. *Id.* § 1.704-1(e)(1)(iii). One factor that may indicate a sham transaction is the “retention of management powers inconsistent with the normal relationships among partners.” *Id.* § 1.704-1(e)(2)(ii)(d). Thus, if a family member attempted to transfer a capital interest to a foundation and retain ultimate management control over the interest by indirect means, Section 704(e) might continue to recognize the donor as the partner for income tax purposes. At no point does Code Section 4943 or its Regulations reference Code Section 704(e) directly, however, so it is unclear whether and how this might apply for excise tax purposes. Presumably, as Code Section 704(e) would affect the determination of a partner’s capital and profits interests under Code Section 704(b), and therefore would apply indirectly. *See* Treas. Reg. § 53.4943-3(c)(2). Section 704(e) was added to the Code as part of the Tax Reform Act of 1976 (Pub. L. No. 94-455, § 213(c)(3)(A), 90 Stat. 1520), six years after the enactment of Code Section 4943. To the extent that Section 704(e) might currently act to constrain some creative partnership capital interest allocations, it could not have acted as such at the time that Code Section 4943 was enacted.

in a partnership is determined with respect to the owner's interest in the partnership upon withdrawal or liquidation.²¹⁷ By implication, however, this section acknowledges that management rights could be transferred with a capital interest in a partnership.

Under the capital and profits test of Code Section 4943, the question of voting control of the partnership becomes essentially irrelevant.²¹⁸ The underlying assumption may have been that, because the capital interests in the partnership would normally be liable for losses on dissolution, the capital interests, therefore, must have been general partners with management rights. This does not appear to be mandated by state law—a limited partner, by definition, belies this assumption. A limited partner has a capital interest in the partnership but is typically unable to be involved in most management decisions other than major life-cycle voting (dissolution, amendment, bankruptcy, etc.) in exchange for the partner's liability protection.²¹⁹ Under a voting control based analysis, limited partners look much like non-voting stock holders. In spite of this similarity, it is very clear that limited partners are not treated in the same manner as non-voting shareholders because the permitted holdings test for partnerships does not look at governance control but at profits interest.²²⁰

217. Treas. Reg. § 1.704-1(e)(1)(v).

218. See Banoff, *supra* note 212, at 254 (“Code Sec. 4943 . . . is unique in its ‘disconnect’ for purposes of measuring ‘relatedness’ with respect to corporate stock and partnership interests, respectively.”).

219. At the time of the enactment of Section 4943 in 1969, the original Uniform Limited Partnership Act passed in 1916 was still the standard for limited partnership statutes, with the first set of major revisions later to occur in 1976. See Nat’l Conference of Comm’rs on Unif. State Laws, *Uniform Limited Partnership Act (ULPA) (2001) (Last Amended 2013): Summary*, UNIF. LAW COMM’N,

http://www.uniformlaws.org/Shared/Docs/Limited%20Partnership/ulpa%20last%20amended%202013%20summary_Jan%202015_GH%20Edits.pdf (last visited Apr. 21, 2015). Under section 7 of the 1916 version of ULPA, a limited partner lost liability protection if, “in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.” UNIF. LTD. P’SHIP ACT § 7 (1916). Section 10 of the 1916 version of ULPA generally gives management power to the general partner. *Id.* § 10.

The most recent version of this legislation, the Revised Uniform Limited Partnership Act (RULPA) was adopted by the Uniform Law Commission in 2001. RULPA § 302 provides that limited partners have no power to act for or bind the limited partnership; however, RULPA § 303 provides that a limited partner is not personally liable for the debts of the partnership “even if the limited partner participates in the management and control of the limited partnership.” UNIF. LTD. P’SHIP ACT §§ 302-303 (2001) (amended 2013). Therefore, under current law, the assumption that a limited partner would not have any governance rights over the partnership would not be entirely correct.

220. I.R.S. Gen. Couns. Mem. 39,195 (Mar. 15, 1984).

D. Permitted Holdings in an “Etc.”

The title to Code Section 4943(c)(3) is “Permitted Holdings in Partnerships, Etc.,” leaving open the possibility that other types of unincorporated business entities might need to be analyzed under Section 4943(c)(3). Section 4943(c)(3)(C) provides the rules for determining permitted holdings in “any other case”—that is, any case that is not a corporation, partnership or joint venture, or sole proprietorship.²²¹ While it appears that this language was aimed primarily (but not exclusively) at capturing holdings of business enterprises held through trusts,²²² by its terms, it should apply to any type of business enterprise not discussed in the other provisions of Section 4943(c).

For these other entities, Section 4943(c)(3)(C) provides that the Secretary of the Treasury should promulgate regulations for determining permitted holdings that are consistent with the corporate rules, with the term “beneficial interest” substituted for the term “voting stock.” Significantly, unlike partnerships, there is no analogous language for “non-voting” stock in an “other unincorporated entity.”²²³

The regulations further provide that a beneficial interest in an “unincorporated business enterprise” other than a partnership is determined with reference to the right to receive profits, or if such amount is not fixed by an agreement among the participants, then by the right to receive assets upon liquidation.²²⁴ If there is no agreement, then beneficial interest is determined on a pro rata basis by dividing the foundation’s contribution by the sum of all capital contributions made (or obliged to be made) to the entity.²²⁵ This formulation of the calculation of permitted holdings looks very similar to the general profit/capital distinction applied by the Regulations to partnerships, with one significant distinction: one cannot use a pure capital interest as a substitute for non-voting corporate stock when reading the corporate rules of Code Section 4943(c)(3)(A) and Treasury Regulation Section

221. 26 U.S.C. § 4943(c)(3)(C) (2012).

222. The title to the applicable regulation is “Trusts and other unincorporated business enterprises.” The Service has ruled that working interests in oil and gas wells should be analyzed under the beneficial interest rule. I.R.S. Priv. Ltr. Rul. 8920012 (Feb. 8, 1989); *see also* I.R.S. Priv. Ltr. Rul. 9715031 (Jan. 13, 1997) (potentially applying Code Section 4943 to a management agreement allowing for a 20% profits interest, although the Service determined that no matter what entity rule applied, there would be no excess business holding due to the 20% cap on profits).

223. Treas. Reg. § 53.4943-3(c)(4)(i) (as amended in 2009).

224. *Id.* § 53.4943-3(c)(4)(iii).

225. *Id.*

53.4943-3(b).²²⁶

As with partnerships and joint ventures, the calculation of permitted holdings of other entities focuses on economic interest and not on governance control. In a private trust, legal control over investments and stock is by definition in the hands of the trustee, who has no beneficial interest in the trust. The beneficial interests held by the beneficiaries of the trust are purely economic in nature.²²⁷ Similarly, for unincorporated business enterprises that are not trusts, the calculation of permitted holdings focuses on economic interests and makes no reference to control of the underlying business entity. Unlike partnerships and trusts, where the underlying laws governing the entities might provide some base assumptions regarding the connection between control and economic interest, there are no such baselines for unincorporated business enterprises—and there cannot be, as Treasury did not know at the time what the legal form of those enterprises actually might be.

E. Permitting Holdings in LLCs: Current Law

Because LLCs did not exist at the time that Code Section 4943 was enacted, the statute does not mention LLCs explicitly. Similarly, the Regulations, which were promulgated primarily in 1977,²²⁸ do not mention LLCs. Accordingly, private foundations are left to shoe horn LLCs into the existing language of a statute that did not contemplate their existence. There are two ways in which the current statute could address LLCs: (1) recognizing the entity's classification as determined under check-the-box or (2) treating the LLC as an "other unincorporated entity" under Code Section 4943(c)(3)(C).

1. Check-the-Box

Code Section 4943 could recognize the check-the-box regime, which would allow an LLC to opt into corporation status or partnership status by election.²²⁹ If the LLC made the election to be treated as a corporation, the LLC would then explicitly avail itself of the corporate permitted holdings rules of Code Section 4943(c)(2), including the use

226. *See id.* § 53.4943-3(b); 26 U.S.C. § 4943(c)(3)(A).

227. Treas. Reg. § 53.4943-3(c)(4)(ii) provides that the beneficial interest in a trust for purposes of Code Section 4943 is held by the remainder beneficiaries as determined under Treas. Reg. § 53.4943-8(b) (2013).

228. T.D. 7496, 1977-2 C.B. 390 (1977).

229. *See also* I.R.S. Priv. Ltr. Rul. 200124022 (Mar. 13, 2001) (treating a single member LLC as a disregarded entity in conformance with the check-the-box regulations).

of non-voting stock.²³⁰ The disadvantage, of course, is that the LLC that elects corporate treatment loses its pass-through income taxation.²³¹

If an LLC did not check the box and, therefore, defaulted to partnership status, the partnership rules would apply. The LLC would have the ability to structure its capital and profits interests in the manner of its choosing—any partner holding a naked capital interest in the partnership would essentially be treated as having non-voting stock.²³² As Code Section 704(b) provides that the allocation of capital interests and profits interests contained in the partnership agreements is respected so long as the allocation has substantial economic effect, the LLC treated as a partnership would have significant leeway in structuring the partnership's capital structure. Thus, it would be possible to give the entire capital interest in an LLC to the private foundation, as long as the ownership of the profits interests in the LLC met the general permitted holdings rule.²³³ It would also be possible to give capital interest to family members that were not otherwise disqualified persons, as the capital interest would not cause the holder to become a disqualified person.²³⁴ As the partnership rules do not care about governance control for purposes of permitted holdings, it appears that the foundation's (or other non-disqualified person family member's) capital interests could be imbued with such governance authority (including voting for the manager or governing members) as the LLC might determine to be appropriate.²³⁵

230. Another benefit of corporate status is that the private foundation may be eligible to use the exception from the self-dealing excise for certain corporate reorganizations under Section 4941(d)(2)(F), which by its terms does not apply to unincorporated entities.

231. One of the reasons why an LLC might elect corporate treatment is so it may apply for tax-exempt status itself. *See generally* Robert W. Fritz, *The Evolving Use of Limited Liability Companies by Tax-Exempt Organizations*, 13 TAX'N OF EXEMPTS 112, 115 (2001). If the LLC were able to establish an independent basis for tax-exempt status, it is likely that the LLC would qualify as a functionally related business under 26 U.S.C. § 4943(d)(3)(A) (citing 26 U.S.C. § 4942(j)(4) (2012)) and therefore be exempt from the limitations of Section 4943 altogether because it would not meet the definition of a "business enterprise."

232. In addition, the holder of a naked capital interest in the partnership would not be a disqualified person by virtue of the holding, as the disqualified person status of a partnership is determined solely with reference to profits interest. 26 U.S.C. § 4946(a)(1)(C)(iii) & (a)(1)(F) (2012).

233. It is clear that the capital interest could not have a corresponding profits interest and be treated as non-voting stock. Thus, limited partnership interests do not automatically qualify as a non-voting stock equivalent, even though a limited partnership interest typically does not have the right to participate in the management of the partnership. I.R.S. Gen. Couns. Mem. 39,195 (Mar. 15, 1984).

234. 26 U.S.C. § 4946(a)(1)(C)(iii) and (a)(1)(F).

235. Subject, possibly, to the family limited partnership rules of 26 U.S.C. § 704(e) (2012), which might work to treat the donor as the continuing partner for purposes of the income tax.

Section 7701 itself appears to support this approach. Section 7701(a), which includes the definitions of the terms “corporation” and partnership,” begins by stating that the definitions in that section apply any time they are used in the whole of Title 26 unless “otherwise distinctly expressed or manifestly incompatible with the intent thereof.”²³⁶ An entity’s classification under Section 7701 is effective for all federal tax purposes,²³⁷ with the certain limited exceptions not applicable here. At the time the check-the-box regulations were written, Treasury could have and did make exceptions to their general applicability to all federal tax matters.²³⁸ It did not make such an exception for the private foundation excise taxes generally or Section 4943 specifically.

2. “Other Unincorporated Enterprise”

Alternatively, the excess business holdings rules could ignore the check-the-box regime and classify entities on the basis of state law. Under this analysis, an LLC is not a partnership for state law purposes and, therefore, would not be analyzed under the capital and profits interest rule of Code Section 4943(c)(3)(A). Rather, the LLC would always be treated as an “etc.”—an unincorporated entity (other than a partnership or sole proprietorship) under state law analyzed under the beneficial interest rule of Section 4943(c)(3)(C). Under this analysis, the LLC’s treatment for excess business holdings purposes would be divorced from its federal tax classification under Section 7701.

For LLCs taxed as corporations, the difference in analysis is significant: the permitted holdings in the corporate LLC are determined based on governance rights, while the permitted holdings for the “other unincorporated enterprise” LLC are based on economic interest. For the LLC taxed as a partnership, it may be that the “other unincorporated enterprise method” and the partnership interest rules under check-the-box align, as the permitted holdings in each are based primarily on a profits/capital distinction. As a practical matter, if the LLC is organized on a straight pro rata basis with regard to profits and capital interest, then

236. 26 U.S.C. § 7701(a) (2012).

237. Treas. Reg. § 301.7701-3(g)(2) (as amended in 2014) provides that the “tax treatment of a change in the classification of an entity for federal tax purposes by election . . . is determined under all relevant provisions of the Internal Revenue Code and the general principles of tax law, including the step transaction doctrine.”

238. As previously mentioned, there are specific exceptions from the wholly owned entity rules for certain excise taxes (not Chapter 42) and for employment taxes. Treas. Reg. § 301.7701-2(c)(2)(v) (as amended in 2014); Temp. Treas. Reg. § 301.7701-2T (as amended 2014).

the result under each rule would be the same.²³⁹ For an LLC treated as a pro rata partnership, the primary difference between the two methodologies comes in the treatment of the non-voting stock equivalent, as the statute explicitly disallows an “other unincorporated enterprise” from substituting a capital interest for non-voting stock.²⁴⁰ Of course, nothing requires the LLC to be a pure pro rata arrangement with regard to capital and profits interests—one of the strengths of the LLC is its flexibility in drafting governance provisions that meet the needs of its members.²⁴¹

If the check-the-box rule is used, the provision in the statute addressing the permitted holdings of unincorporated entities would essentially be applied to joint ventures and co-ownership arrangements that did not rise to the level of a business entity.²⁴² Under the check-the-box rules, all other business entities would be either corporations or partnerships. This would be contrary to the current interpretation of the statute in the Regulations, which explicitly details rules for determining a private foundation’s permitted holdings in an unincorporated entity other than a trust—these provisions would essentially become obsolete, at least until the next new state law business entity type comes along.²⁴³

3. So Which One Is It?

Sadly, based on a review of existing administrative guidance, it is not clear which path is the correct one. Because the results in many situations are essentially the same, it can lead to confusion on the path taken to get to those results.

In many cases, the IRS has disposed of the excess business holdings issues involving LLCs on the basis that the LLC is not a “business enterprise.” As indicated previously, the excess business holdings rules applies to private foundation holdings in a “business

239. See I.R.S. Gen. Couns. Mem. 39,195 (Mar. 15, 1984) (limited partnership interests with pro rata shares of both profits and capital are not equivalent to non-voting shares).

240. 26 U.S.C. § 4943(c)(4)(B) (2012).

241. See REVISED UNIF. LTD. LIAB. CO. ACT § 110 cmt. (2006) (“A limited liability company is as much a creature of contract as of statute. . . . The operating agreement is the exclusive consensual process for modifying this Act’s various default rules pertaining to relationships *inter se* the members and between members and the limited liability company.”).

242. The only other arrangements that might be covered would be co-ownership arrangements, although many of these could rise to the level of a partnership or joint venture, which are clearly governed by Code Section 4943(c)(3)(A). See, e.g., I.R.S. Priv. Ltr. Rul. 8920012 (Feb. 8, 1989) (working interests in oil and gas properties held directly by a foundation possibly analyzed as an unincorporated business enterprise).

243. See Treas. Reg. § 53.4943-3(c)(iii) (as amended in 2009).

enterprise”; if an entity is not a “business enterprise,” then Section 4943 simply does not apply.²⁴⁴ Code Section 4943(d)(3) specifically provides that an entity is not a business enterprise if 95% of its gross income is generated from passive sources.²⁴⁵ Thus, many rulings find that LLCs are not business enterprises due to the 95% passive income rule. In those rulings, the IRS’ discussion of the permitted holdings rules for LLCs is not determinative of the outcome of the ruling and, therefore, is often vague or incomplete.

For example, in Private Letter Ruling (PLR) 201333020,²⁴⁶ the IRS leans toward a check-the-box analysis, but this analysis is not determinative for purposes of the ruling. In this case, a private foundation held an interest in a hedge fund. The hedge fund was organized as an LLC and taxed as a partnership for federal income tax purposes.²⁴⁷ Another member of the LLC held all of the Class B membership interests in the LLC, which represented a 10% income interest in the LLC. This member proposed to give all of the Class B membership interests to the private foundation.²⁴⁸ In reciting the law applicable to the foundation’s permitted holdings in the LLC, the IRS noted that a private foundation is allowed 20% of the voting stock of a corporation reduced by the holdings of its disqualified persons.²⁴⁹ It went on to state that “I.R.C. §4943(c)(3) provides that for interest in any partnership or joint venture the word ‘profit interest’ should be substituted for the word ‘voting stock’ in the definition of permitted holdings.”²⁵⁰ Note that, while the ruling did not cite specifically to the partnership rule (§ 4943(c)(3)(A)), it did mention that it was applying the partnership rule.²⁵¹ The ruling made no mention of unincorporated enterprises other than partnerships, which would have been covered by § 4943(c)(3)(C). Later in the ruling, it again discussed the partnership rule (with citation to § 4943(c)(3) as a whole), although it is not

244. 26 U.S.C. § 4943(a).

245. *Id.* § 4943(d)(3)(B). Passive sources include the items excluded from the unrelated business income tax under Section 512(b)(1), (2) and (5) as well as the income from the sales of goods not manufactured or actively distributed by the entity. *Id.* § 4943(d)(3) (flush language).

246. I.R.S. Priv. Ltr. Rul. 201333020 (Aug. 16, 2013) (LLC that was taxed as a partnership for federal income tax purposes operated an investment hedge fund; LLC was not a business enterprise within the meaning of Section 4943(d)(3), but the IRS also noted that “the holdings of the LLC will not be excess business holdings”).

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

determinative of the ruling.²⁵² Once again, the IRS held that the hedge fund would not be a business enterprise that was even subject to Section 4943, although it went on to state that “the holdings of LLC will not be excess business holdings” without further analysis.²⁵³ Although it is not entirely explicit, it certainly looks like the Service was leaning toward analyzing the LLC as a partnership under § 4943(c)(3)(A) and not as an unincorporated business entity under § 4943(c)(3)(C).

On the other hand, PLR 200650018, which discussed a private foundation’s excess business holdings in an LLC that owned farm property and operations,²⁵⁴ appears to use the “other unincorporated enterprise” rule for analyzing LLC permitted holdings. This PLR noted, “under section 4943(c)(3) a private foundation is permitted to hold up to twenty percent of the profits interest in an unincorporated business enterprise.”²⁵⁵ As with the citation in PLR 201333020 (discussed above), the ruling citation did not distinguish between the partnership rule (contained in § 4943(c)(3)(A)) or the other unincorporated entity rule (contained in § 4943(c)(3)(C)), although it did use the term “unincorporated business enterprise.”²⁵⁶ Later in the PLR, the IRS noted that the foundation would have an excess business holding because its “ownership and profits interests in the Farm and [LLC] . . . both exceed twenty percent.”²⁵⁷ At first glance, this appears to be a partnership analysis,²⁵⁸ however, the Regulations for other unincorporated associations discuss analyzing a beneficial interest with reference to, first, a profits interest and then to a dissolution or liquidation interest—which is a similar (although not identical) test for a capital interest in a partnership. The ruling did not use the term “capital” interest but rather talked about “ownership.”²⁵⁹ The PLR itself was a request for an extension of the five-year period in which a private foundation must dispose of certain excess holdings—as a result, the PLR was able to address the extension issue while still stating, “We do not rule on whether your interest in the LLC constitutes an excess business

252. *Id.*

253. *Id.*

254. I.R.S. Priv. Ltr. Rul. 200650018 (Sept. 21, 2006).

255. *Id.*

256. *Id.*

257. *Id.*

258. *See also* I.R.S. Priv. Ltr. Rul. 200517031 (Feb. 2, 2005) (finding no excess business holdings on other grounds, but citing the partnership rules found in Treas. Reg. § 53.4943-3(c)(2) as the basis for determining the permitted holdings in an LLC).

259. *Id.*

holding.”²⁶⁰

Distributions from limited partnerships, themselves, can be deemed passive income.²⁶¹ In PLR 200611034, the Service stated that “[l]imited partner interests are passive investment that are comparable to stock and securities. As with a holder of corporate stock, a limited partner does not participate in the trade or business.”²⁶² In support of this proposition, the Service noted that the characterization of limited partner interests as passive, and therefore not business enterprises altogether, is compatible with the purpose of Section 4943. “One of the concerns of lawmakers was that foundation managers paid too much attention to the maintenance and improvement of business interests to the detriment of the time and energy expended on charitable duties.”²⁶³ The IRS was comfortable with this ruling because traditional notions of limited partnership provide that the limited partner could not be involved in the management of the business. Therefore, by definition, the foundation, as a limited partner, could not be diverted away from charitable activities by his or her involvement in the limited partnership, as there was no such involvement.

If a private foundation held a capital interest in an LLC that was taxed as a partnership under the check-the-box rules, nothing in the language of Code Section 4943 or in the statutory framework of most state enabling statutes would prevent the private foundation from having governance rights. Thus, the underlying assumption that a diversion from charitable activities cannot happen with a limited partner due to the state law prohibition on the exercise of most administrative powers by a limited partner does not work with an LLC.²⁶⁴

IV. OPTIONS FOR INCORPORATING LLCs EXPLICITLY INTO SECTION 4943

A. *Framework for Evaluating Options*

The discussions that preceded the enactment of Code Section 4943

260. *Id.* See also I.R.S. Priv. Ltr. Rul. 200438042 (Sept. 17, 2004) and I.R.S. Priv. Ltr. Rul. 200438043 (Sept. 17, 2004) (citing but not analyzing the unincorporated business enterprise rules in a request for the extension of the five-year period to dispose of holdings in an LLC taxed as a partnership for federal income tax purposes).

261. I.R.S. Priv. Ltr. Rul. 200611034 (Mar. 17, 2006).

262. *Id.*

263. *Id.* (citing H.R. Rep. No. 413 Pt. 1, at 27 (1969); S. Rep. No. 552, at 38-39 (1969)).

264. The current version of the Revised Uniform Limited Partnership would grant limited partners a greater ability to participate in limited partnership management without losing limited liability. See UNIF. LTD. P'SHIP ACT §§ 302-303 (2001) (amended 2013).

indicate that Congress saw the private foundation as an important vehicle to advance “individual experimentation and the exercise of creative imagination” in the public space.²⁶⁵ The 1965 Report adopted a pluralism theory of tax exemption,²⁶⁶ which emphasizes the need for charitable vehicles that encourage innovation and diversity of thought. Pluralism theory posits that the nonprofit sector, controlled by neither government nor business, provides an outlet for discourse and debate that is not beholden to these interests.²⁶⁷ Nicholas Cafardi, in a speech on the necessity of the nonprofit sector, stated:

Imagine, if you will, an America in which the public discourse is

265. 1965 REPORT, *supra* note 1, at 35.

266. BRUCE R. HOPKINS, *THE LAW OF TAX EXEMPT ORGANIZATIONS* §1.3, at 9-11 (10th ed. 2011); Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, (1997) (viewing promotion of pluralism and diversity as a “metabenefit” under traditional subsidy theory); John G. Simon, *Charity and Dynasty Under the Federal Tax System*, 5 PROB. LAW. 1, 70 (1978) (citing various examples of critical foundation support for “dissenting and unorthodox ideas”).

267. Lawrence M. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 1968 U. SO. CAL. L. CTR. TAX INST. 27, 39-40 (“charity . . . provides a unique and flexible form of social organization that counterbalances the vast power of government and the concentrated wealth of the private sector”); Simon, *supra* note 266, at 74. *See also* Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO. ST. L.J. 1379, 1430-31 (1991) (citation omitted) (discussing “classic liberalism and the value of pluralism” in the context of a donative theory of tax exemption, where “the charitable subsidy [is] distributed automatically based on autonomous decisions by individual donors that determine which activities within the nonprofit sector are socially valued”).

The notion that, free from government and business interference, a charity would be unfettered in its pursuit of its charitable goals is not without its flaws. For example, without the ability to offer stock, nonprofits are unable to access equity markets to fund their charitable activities. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980) (tax-exempt status is justified to compensate nonprofits for their inability to access capital due to the non-distribution constraint). Accordingly, nonprofits must find other sources of funds—for the private foundation, that typically means contributions from its founder, his or her family members, and affiliated businesses. The nonprofit is then at the whim of its donors if it does not have an independent source of funding. If the strength of the foundation is its ability to realize the ideas of innovative thinkers, its flaw is its compulsion to follow the whims of idiosyncratic donors. *See* Simon, *supra* note 266, at page 69 (“One can imagine a *second*, somewhat less elitist, proposition that might go like this: whether or not wealthy givers are better suited to uphold cultural and intellectual standards, affluent individuals are more likely to be idiosyncratic or unorthodox. . . . Whatever the reason, such idiosyncrasy or heterodoxy is more likely to result in a charitable product that is different from what majoritarian preferences might produce, thus justifying the inegalitarian charitable deduction in the name of pluralism”). At least in the case of the private foundation, contributions already received can produce a flow of funds that would support its charitable mission even if no further donations were received. *See generally* Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 461 (1996) (“Each of the nonprofit’s constituents has its own goals, which can be furthered either by exercising ‘voice’ (imposing conditions on the donation or contract) or ‘exit’ rights (withholding future donations or dealings).”).

controlled and the public agenda is set by a confluence of government and commerce, without anyone to say them nay. What kind of America would that be? I suggest to you that it would not be a very free America.

Something more is needed, something that keeps government and business from controlling our entire way of life. This is what the [nonprofit sector] does. Its very existence guarantees the lively public debate that makes American society so unique in the world²⁶⁸

It is clear from the discussion in the 1965 Report that Congress valued the unique role that private foundations played in the charitable sector specifically and in society generally. At the time, many critics advocated for abolition of the private foundation or at least imposition of a requirement of full payout of all assets within a short time frame.²⁶⁹ Congress resisted these calls by highlighting the unique strengths of the private foundation.²⁷⁰ Private foundations provided a dedicated endowment for charitable purposes, thus ensuring the long-term viability of the charitable sector generally. A private foundation is not, however, wedded to another charity like other types of endowments, such as the university endowment or the supporting organization.²⁷¹ Accordingly, the private foundation has the flexibility to vary its beneficiaries in a way that other endowment-type organizations cannot. A private foundation can support multiple causes and adapt and change its funding streams as projects may require.

It is this flexibility that Congress appeared to value most.²⁷² As a private foundation does not need to appeal to a broad cross-section of the general public for funding, it is free to pursue those projects and issues that it determines to be appropriate.²⁷³ In furtherance of these projects, it can impose requirements and outcomes through its grant agreement. It can agree to multi-year funding in order to provide stability to a

268. Nicholas P. Cafardi, Address at the Meeting of the Westmoreland County Bar Ass'n: The Third Sector (Nov. 13, 1992), in *TAX EXEMPT ORGANIZATIONS: CASES AND MATERIALS* 123 (Nicholas P. Cafardi & Jaclyn Fabean Cherry eds., 2d ed. 2008).

269. Crimm, *supra* note 9, 1114-15.

270. 1965 REPORT, *supra* note 1, at 11-12.

271. Public university endowments are typically public charities under Code Section 509(a)(1) by virtue of being described in Code Section 170(b)(1)(a)(iv), which requires the expenditures to be made to or for the benefit of a public college or university. In order to qualify as a public charity by virtue of being a supporting organization, the supporting organization must have a defined relationship with one or more other public charities (called supported organizations) and may not make distributions for any other purpose. *See generally* 26 U.S.C. § 509(a)(3) (2012).

272. 1965 REPORT, *supra* note 1, at 12.

273. *Id.*

project;²⁷⁴ it can also provide that funding can be withdrawn in order to encourage individual projects to find other funding in the marketplace of charitable ideas. As the private foundation is not bound to a particular charity (except for its own voluntary grant agreements), it can pivot to other grant recipients or even other projects as it deems necessary.²⁷⁵ This may be because a project has been successfully completed, because the project was a worthy but ultimately unsuccessful experiment, or because the problem to be address has changed in some way to make the project moot.²⁷⁶ Regardless of the reason, Congress believed that the flexibility of the private foundation put it in a unique position to fund innovation and add to the pluralism of ideas in the charitable sector.

Through the excess business holdings excise tax, Congress sought to protect and enhance a private foundation's innovative approach to charity by requiring the foundation's attention and assets to be focused on these creative philanthropic endeavors.²⁷⁷ Thus, in the corporate context, the statute prevents the diversion of a private foundation's attention toward business endeavors by limiting the private foundation's ability to hold stock (using, perhaps inadvisably, partnership profits/capital distinction as a flawed proxy²⁷⁸ for control).²⁷⁹ As indicated, however, this limitation did not extend to passive income, as Congress understood that part of the job of a private foundation is to invest and grow its assets.²⁸⁰ Similarly, it did not extend this to functionally related businesses, as there was an acknowledgement that

274. For example, for purposes of meeting the mandatory distribution requirements of Code Section 4942, a private foundation may, under certain circumstances, set aside funds for a multi-year, specific project but treat them as distributed in the year of the set-aside. *See* 26 U.S.C. § 4942(g)(2) (2012).

275. Code Section 4945 generally allows a private foundation to fund charitable activities (within the meaning of Code Section 170(c)(2)(b)) carried on by any entity—even a for-profit entity. 26 U.S.C. § 4945(d) (2012). There are, however, administrative requirements for certain grants to individuals and grants to non-public charities ostensibly designed to ensure that a non-public charity will dedicate the funds to charitable purposes. *See id.* § 4945(g)-(h).

276. Of course, the downside of all of this flexibility is that charitable assets may be wasted on the larks of wayward boards. With no shareholders to constrain spending, there is little impetus to control for waste—especially in the endowed foundation, where the funding stream continues unabated into perpetuity—or at least as long as the investment managers do their jobs. *See generally* Brody, *supra* note 267, at 463-64.

277. Stone, *supra* note 267, at 51.

278. Banoff, *supra* note 212, at 255 (criticizing the use of partner capital and profits interest as a measure of relatedness, stating, “[i]f the concern underlying ‘relatedness’ is manipulation or collusion for tax purposes by a partner and his controlled partnership, ‘control’ can be defined other than by reference to [profits, capital], or the relative value of the partners’ interests”).

279. For a critique of the argument that holding voting stock is tantamount to operating business involvement, see Schmalbeck, *supra* note 19, at 84.

280. *Id.* at 61-2; *see also* 1965 REPORT, *supra* note 1, at 11.

charitable purposes could be furthered through investments in businesses.²⁸¹

When evaluating the options for incorporating LLCs explicitly into the statutory provisions of Section 4943, one could simply be guided by this original Congressional intent. There is the possibility that Congress' original intent, while well-meaning, is sufficiently dated as to no longer provide appropriate guidelines for informing future revisions to Section 4943's statutory and regulatory provisions. An argument can still be made, however, that the tensions that informed the passage of Code Section 4943 in the 1960s remain relevant today. One need look no further than the current debate over social enterprise to see this same issue up for discussion today: how can the legal framework regulating charities encourage the flexibility to allow people to creatively address social problems while preventing the misuse of charitable assets?

One of the strengths of the social enterprise entity is its flexibility—it is not constrained by nonprofit limitations or corporate benefit maximization directives. A social enterprise typically combines in a single entity the dual missions of profit seeking through active business operations and the accomplishment of charitable goals—the exact combination of activities that Congress attempted to regulate through the enactment of Code Section 4943.²⁸² Proponents of social enterprise posit that the combination of for-profit methods and the charitable outcomes need not be in conflict with one another. Rather, in the correct combination, business goals and methodologies can enhance, not distract from, the foundation's charitable mission.²⁸³ In fact, social enterprise highlights the synergies of business and charity that will encourage “individual experimentation and the exercise of creative imagination”²⁸⁴ in the entrepreneurial-minded²⁸⁵—the same result professed to be the

281. 26 U.S.C. § 4943(d)(3)(A) (2012) (excluding functionally related business from the definition of business enterprise.)

282. John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 117 (2010) (stating the L3C “unites in one enterprise two principles often considered irreconcilably in competition with each other: pursuing charitable exempt purposes and generating and distributing profits”).

283. The Social Enterprise Alliance is one of the primary organizations promoting social enterprise, stating that social enterprise is the “Missing Middle,” combining efficiency, sustainability, creativity, and generosity in a way not seen in the traditional sectors of the economy. See *What We're All About*, SOC. ENTERPRISE ALLIANCE, <https://se-alliance.org/why#whatwereallabout> (last visited Nov. 14, 2014); see also Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009).

284. 1965 REPORT, *supra* note 1, at 35.

285. Mayer & Ganahl, *supra* note 8, at 427 (stating, “Social entrepreneurs . . . desire the flexibility to seek non-traditional approaches in conducting their business and to access a broad

benefit of private foundations according to the 1965 Report.

While the possibility of synergy exists, the tension between business and charitable goals within social enterprise remains. One of the issues that Code Section 4943 was intended to address was whether the attention of a private foundation was focused on its charitable mission or diverted to business endeavors. Similarly, one of the perceived weaknesses of social enterprise (at least from a nonprofit perspective) is that there is little guidance on exactly how “charitable” a social enterprise must be, both at inception and operationally. While most state L3C enabling statutes at least require the charitable purpose of the enterprise to be significant,²⁸⁶ there is no similar requirement in most benefit corporation legislation.²⁸⁷ In fact, in the benefit corporation context, many statutes specifically give the board of directors of the benefit corporation, when contemplating corporate actions, the ability to weigh various interests—including, but not limited to, its shareholders and its public purpose.²⁸⁸ The statute is quite clear that unless the organization’s articles of incorporation state to the contrary, no particular interest (including the public purpose) is given priority over another.²⁸⁹

As noted by Professor Dana Brakman Reiser in her review of Google.org, Google’s for-profit philanthropic arm, “[w]hat begins as philanthropic mission could, as a result of it being embedded within a business, become biased toward alignment with the goals of the for-profit company.”²⁹⁰ Similarly, practical considerations regarding the

range of capital”).

286. *See, e.g.*, 805 ILL. COMP. STAT. ANN. 180/1-26(a) (LexisNexis through the 2014 Reg. Sess.) (“A low-profit limited liability company shall at all times significantly further the accomplishment of one or more charitable or educational purposes . . .”). This requirement was originally intended to comply with the requirements for program-related investments as described in another private foundation excise tax from 1969, the jeopardizing investment excise tax of Code Section 4944. *See* 26 U.S.C. § 4944(c) (2012).

287. *See, e.g.*, W. VA. CODE ANN. § 31F-3-301 (LexisNexis 2014) (“A benefit corporation shall have as one of its purposes the purpose of creating a general public benefit.”). Connecticut’s benefit corporation legislation includes language attempting to make sure that any benefit corporation assets stay within the charitable or social enterprise realm. CONN. GEN. STAT. ANN. § 33-1355 (West, Westlaw through Jan. 1, 2015). For a review of the status of social enterprise organizations in the various states, see Cass Brewer, *Social Enterprise Law Update and Map*, SOCENT L. (Aug. 11, 2014), <http://socentlaw.com/2014/08/social-enterprise-law-update-and-map/>.

288. *See, e.g.*, W. VA. CODE ANN. § 31F-4-401(a)(1) (LexisNexis 2014).

289. *See, e.g., id.* § 31F-4-401(a)(3). *See also* Mayer & Ganahl, *supra* note 8, at 426 (discussing the perils inherent in balancing the interests of the multiple stakeholders of a benefit corporation).

290. Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2465 (2009).

manner in which social enterprises raise capital and interact with profit-motivated investors may inform (or skew) the way a particular entity balances its business and charitable goals.²⁹¹

One of the other purported goals of Code Section 4943 was to prevent the potential for subtle acts of self-dealing. Attempting to analogize Code Section 4943 to social enterprise with regard to the misuse of charitable assets poses a fundamental issue. Unlike the private foundation, which is forbidden from making distributions for the personal benefit of its foundations, the social enterprise organization explicitly may. Indeed, that is part of the point of the social enterprise organization.

Are the assets of a social enterprise organization charitable at all? Critics have highlighted this issue of “is it charitable?” as a potential concern regarding the regulation of the social enterprise organization. In this context, there are more questions than answers. If the social enterprise organization is using its charitable purpose as part of an appeal for capital, but the assets are not so used, is there a risk of misleading donors/investors that should be addressed by solicitation or similar legislation?²⁹² If assets given to a social enterprise organization are supposed to be used for charity, does that give regulators on the state and federal level the ability to enforce that use?²⁹³ If some of the assets of a social enterprise are, in fact, dedicated to charity, how much benefit can accrue to the enterprise’s owners before it is too much?²⁹⁴

291. Dana Brakman Reiser, *Benefit Corporations – A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 609-10 (2011).

292. *Id.* at 615 (critiquing the benefit corporation’s reporting mechanism, which is intended to inform shareholders and other constituents of the social benefit activities of the organization); Mayer & Ganahl, *supra* note 8, at 436 (“The public perception that charitable enterprises are valuable and deserve subsidy is vulnerable, however, and attempts by hybrid promoters to tap into that sentiment could have serious consequences.”).

293. Illinois’ L3C legislation is fairly unique in that it explicitly subjects an L3C to the state’s Charitable Trust Act, which in turn authorizes oversight by the Attorney General. *See* 805 ILL. COMP. STAT. ANN. 180/1-26(d) (LexisNexis through the 2014 Reg. Sess.); Charitable Trust Act, 760 ILL. COMP. STAT. ANN. 55/1 (LexisNexis through the 2014 Reg. Sess.); Mayer & Ganahl, *supra* note 8, at 432-36 (discussing the weaknesses of current oversight of social enterprise organizations); Tyler, *supra* note 282, at 150 (arguing that traditional charitable nonprofit enforcement tools are not appropriate for social enterprise organizations); Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy*, 85 CHI.-KENT L. REV. 571 (2010).

294. *See, e.g., supra* note 287 (discussing Connecticut’s attempt to insure that assets contributed to a social enterprise would be “locked in” to those purposes). In the federal income tax context, Mayer and Ganahl in *Taxing Social Enterprise* consider the issues that would arise if the Internal Revenue Code provided tax benefits to social enterprise in order to subsidize socially beneficial behavior and reward risk-taking, but note that if the entity ultimately turns a profit, then “the profits (and the subsidy) will flow to investors, providing a private benefit”. Mayer & Ganahl, *supra* note 8, at 429.

Although there are few, if any, answers to these questions in the social enterprise context, we can look back to see how Congress struggled to answer similar questions in the context of Code Section 4943. If an organization holds itself out to the public as charitable and, as a result, benefits from tax-exemption, should the public expect a certain level of charitable use? Is there a role for state and federal regulators in enforcing this expectation? And how much can the founders of the foundation benefit from otherwise charitable assets before it is too much? In passing all of the private foundation excise taxes, Congress clearly answered “yes” to all of these questions and tried to draw the lines that are only now faintly seen in the social enterprise context.

The social enterprise debate highlights the continuing desire for legal frameworks that provide the nonprofit sector with the flexibility²⁹⁵ to foster innovation in addressing social need with the attendant danger of diversion of charitable assets and attention—the same concerns present in the debate over Code Section 4943 in the 1960s. Although traditional pluralism concerns may, to some, seem outmoded, they appear to be alive and well in this modern form. If these discussions are distilled down to a general framework, any revisions to Code Section 4943 to address LLCs should:

- ensure organizational attention to charitable purpose;
- while allowing for flexibility to pursue charitable purposes;
- minimize the potential for subtle acts of self-dealing not otherwise captured by Code Section 4941; and
- allow for modern investment activities that provide for a reasonable inflation-adjusted return at an appropriate level of risk, all while
- provide clear guidance for the IRS, the donating public, private foundations and the rest of the nonprofit sector, and

295. Benjamin M. Leff, *Preventing Private Inurement in Tranched Social Enterprises*, 45 SETON HALL L. REV. 1, 3 (2015) (citing Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 233 (2006) (the tax regime applicable to nonprofits “is sometimes not flexible enough to accommodate . . . new ideas and methods”)) (new social enterprise entities are “‘deregulatory,’ in the sense that the new business forms are intended to free social enterprise from a variety of laws that constrain the ‘traditional’ nonprofit sector”); Mayer & Ganahl, *supra* note 8, at 427 (“Hybrids are widely lauded for their ability to aid entrepreneurs seeking better solutions to social needs due to their simplicity and flexibility”); Kelley, *supra* note 283, at 340-41 (social enterprise “entrepreneurs claim to inhabit a frontier where outmoded law and inappropriate old-style legal entities hamstringing their socially transformative plans”).

the investment community.

With these goals established by a framework of pluralism as originally professed by Congress in 1965, and updated and informed by the concerns about the interaction of business and charity as voiced in the debate over social enterprise, it is possible to evaluate the alternatives to the treatment of LLCs under Code Section 4943.

B. The Unincorporated Association Route

One could simply take the language of Code Section 4943 at face value and treat LLCs as that which they are: unincorporated business enterprises. Clearly, Congress contemplated that there would be ownership structures that would not fall into one of the neat categories of corporation and partnership, which would need to be addressed in some manner. Given that a statutory catch-all category exists, it seems like the obvious answer would be to use it.

This approach overestimates the value of the catch-all category. If one looks at the types of abuses that Congress considered at the time of the passage of Section 4943, this category appears to have been intended for trusts and co-ownership arrangements, especially for real property.²⁹⁶ At no point does it appear there was any thought that Code Section 4943 needed the flexibility to address emerging forms of business ownership, although it may have been a happy by-product of the statutory language. The use of the term “beneficial interest” as the statutory measure of permitted holdings provides private foundations with little guidance as to how to comply.

For this reason, there does not appear to have been the level of Congressional focus on the manner in which permitted holdings should be calculated for any of the non-corporate holdings, not to mention the other unincorporated business enterprise provisions. All of the focus, as demonstrated in Part II of this Article, was on corporate holdings, with barely a mention of the partnership, never mind other potential forms of business ownership.

By focusing on beneficial interest as the measure of ownership, the unincorporated association rules do not address the fundamental concerns that Congress had when passing Code Section 4943 in the LLC context. If the primary concern is control (and the attendant diversion of

296. For example, see the co-ownership and real estate easement examples in the 1965 Report. The language chosen for the statute—“beneficial interest”—comports with this understanding. 1965 REPORT, *supra* note 1, at 19-20, 30.

attention), the beneficial interest rule does not address that issue in any way. This may be a fundamental flaw of both Section 4943(c)(3)(A) and Section 4943(c)(3)(C), in that both the partnership and the other unincorporated entity rules focus on economic interest and not on control.²⁹⁷ At least in the context of the general partnership, it may have been reasonable to conclude at the time that control would follow beneficial interest, although clearly the limited partnership was there for consideration.

The control issue becomes even more pronounced with the LLC, however, given that the strength of the LLC from a state law perspective is flexibility in both economic structure and governance while preserving corporate-style limited liability. The LLC provides more significant opportunities for combinations of economic interest and governance control than ever before, which may not have been contemplated given Congress' understanding of business structures available at the time.

Simultaneously, the unincorporated business entity rules of Section 4943(c)(3)(C) are too narrow for modern investing practice, as they do not allow for a private foundation to have an analog to non-voting interests. It is not uncommon for private foundations to invest through hedge funds, and other collective investment vehicles, which can be in LLC form. Private foundations have very little control over the investments in these funds—in some instances, foundations struggle to even know what the fund holds.²⁹⁸ It does not appear that Congress intended to curb legitimate and accepted means of investing the foundation's portfolio through Code Section 4943. Rather, Section 4943 should be able to adapt and encourage modern investment portfolio theories and techniques, while limiting direct control over operating businesses, which the unincorporated association route may not do.

C. *Respect Check-the-Box*

The path of least resistance would be simply to respect the classification of an entity under the check-the-box regime. Corporations would continue to be corporations; partnerships (both limited and general) would be partnerships. LLCs, to the extent not disregarded, would be partnerships unless the specific LLC had checked the box to elect corporate treatment. Permitted holdings in the LLC would then be analyzed under either the corporate rules of Section 4943(c)(2) or the

297. Banoff, *supra* note 212, at 254.

298. *See id.* at 209 n.90.

partnership rules of Section 4943(c)(3)(A). The other unincorporated business entity rules of Section 4943(c)(3)(C) simply would not apply.

The benefit of this approach is that it utilizes the existing mechanics of Section 7701, with which one assumes most LLCs are already familiar. It allows the entity the flexibility to order its affairs in the manner most appropriate to its business model and to take advantage of the governance innovations inherent in LLCs. It would also be easy to administer, as the classification of the LLC and the analysis of permitted holdings would be relatively mechanical once the tax classification of the entity was established. Finally, it comports with the general understanding of the scope of the check-the box rules—they apply for all federal tax purposes unless specifically excepted by regulation.

This model is also inherently flawed for two reasons. While the simplicity and symmetry of the approach is compelling, it does not adequately address Congress' fundamental concern about active involvement of private foundations in business affairs.

In the case of the LLC taxed as a partnership, the concern over active involvement flows from the original statutory choice to judge permitted holdings of pass-through entities based on economic interest rather than governance control. While economic interest and governance control may often coincide, that is certainly not a result mandated by state statute. In the case of the unincorporated enterprise, Congress had to assume that beneficial interest and governance control would align—it had no basis upon which to presume otherwise—and it guarded against the possibility by not allowing for an analogous holding similar to non-voting stock.²⁹⁹ As discussed previously,³⁰⁰ it appears that an LLC could be set up to give voting rights to the holders of the capital interest of the LLC. As the statute provides that capital interests in the LLC taxed as a partnership are analogous to non-voting stock, these interests could be unlimited so long as 20% or less of the profits interest is held by disqualified persons.³⁰¹

If an LLC checks the box to be taxed as a corporation, then permitted holdings would be determined based upon the power to elect the “directors” of the organization.³⁰² But who are the “directors” of an LLC? In an LLC with voting equity members and a Board of Managers

299. Cf. 26 U.S.C. § 4943(c)(3)(A) (2012) (allowing for capital interests to be treated as nonvoting stock for partnerships) *with id.* § 4943(c)(3)(C) (not allowing an analogous interest for nonvoting stock in the case of other unincorporated enterprises).

300. See *supra* Part II.E.2.

301. 26 U.S.C. § 4943(c)(3)(A) & (c)(3)(C).

302. Treas. Reg. § 53.4943-3(b)(1)(ii) (as amended in 2009).

elected by the members, we can treat the members as shareholders and the Board of Managers as the directors. But what if the LLC operating agreement seriously limits the power delegated to the manager, so that office is more akin to a chief administrator rather than a policy setting body? Should we disregard the manager and treat the members as both “directors” and “shareholders”? But in such a case, or in the case of a member-managed LLC, the members are not elected—they have governance rights because they are, essentially, shareholders. In that case how does the corporate voting test (a vote for the directors) apply? If a foundation did not have the right to vote for the “directors”—whomever they may be—then all of the foundation’s holdings would be permitted holdings if only 20% of the voting equity was held by disqualified persons.³⁰³ For example, assume that the manager in a manager-managed LLC is deemed to be the “director” for purposes of determining what voting stock might be. If 80% of the power to vote for the manager is given to non-disqualified persons (such as a sibling, niece, or nephew of the founding donor³⁰⁴), could the foundation retain all other powers of governance inherent to a member and be able to hold an unlimited amount of such equity? Given the almost unlimited ability to tailor the governance of the LLC as desired, query whether the corporate voting test, without further definition, is adequate addresses the concern about corporate control inherent in Code Section 4943 for LLCs taxed as corporations.

In either case, the potential for mischief in the form of retained foundation control seems apparent. It may be that this mischief is ultimately restrained, for the most part, by the limitation that only 20% of the voting interest (however it is ultimately defined) in an LLC is taxed as a corporation³⁰⁵ or 20% of the profits interest of a partnership may be owned by disqualified persons.³⁰⁶ Even so, the ambiguity remains problematic for those foundations that are interested in investing in LLCs as a matter of an allocation to an alternative equity investment as part of its regular portfolio.

303. *See id.*; 26 U.S.C. § 4943(c)(3)(C).

304. For purposes of determining a foundation’s disqualified persons, the definition of a “member of the family” for purposes of Code Section 4943 does not include the siblings of a substantial contributor or foundation manager, or any of the sibling’s descendants. *Compare* 26 U.S.C. § 4943 *with* 26 U.S.C. § 4958(f)(4) (2012) (including siblings and their spouses within the meaning of member of the family for purposes of the excess benefit transaction excise tax applicable to public charities).

305. 26 U.S.C. § 4943(c)(2).

306. *Id.* § 4943(c)(3)(A).

D. A Proposal: Modified Check-the-Box

Despite its flaws, check-the-box provides clear guidance to private foundations with minimal administrative burden to Treasury and is consistent with the treatment of entity classification across the Code. That being said, LLCs are not corporations, and they are not partnerships—that is the strength of the LLC. They allow the flexibility to combine economic interest and governance rights in as many varied ways as the creative drafter can imagine. Thus, neither the unincorporated association option nor a pure check-the-box regime sufficiently protects against the issue of business involvement and diversion from charitable endeavors.

In the best of all worlds, the check-the-box rules would be respected but the statutory partnership rules would be changed, such that the analog to voting stock would be a general partnership interest and the analog to non-voting stock would be a limited partnership interest with no management rights. Such a test would prevent gamesmanship with capital/partnership interest and would provide a bright-line test for ownership for both limited partnerships and LLCs taxed as partnerships. It would also allow private foundations to invest in modern alternative investment opportunities in limited partnership form without limitation. Consistent with the current rules, no more than 20% of the general partnership interests could be held by disqualified persons. In most such cases, the general partner of those partnerships is an unrelated entity that is managing the fund; therefore, all of the issues of control and attention do not come into play with such an investment, as the limited partner is truly a passive investor.

In the case of LLCs, since there is no general partner with unlimited liability, the measure of permitted holdings should depend upon how the LLC is organized. In a member-managed LLC, all of the equity owners have governance rights by default, and therefore, all should be treated as analogous to general partners even though they have no liability. It should be possible, however, to draft for a class of membership interest in a member-managed LLC that disclaims all governance rights so it looks more like a limited partnership interest. By way of example, the allowable rights that could be retained by a limited partner might be those consent rights currently provided as default rights in the Uniform Limited Partnership Act of 2001, which includes admission of partners, amendment of the partnership agreement, expulsions, conversion,

merger, and dissolution.³⁰⁷ If there are non-management members, then those individuals would be treated as non-voting members as long as 20% or less of the management member interests was held by non-disqualified persons.

Similarly, in the case of manager-managed LLCs, the manager or the board of managers would be treated as if they were a board of directors. Thus, all of the members entitled to vote for the manager would be treated as voting shareholders, subject to the 20% rule. To be considered a non-voting shareholder with the power to hold unlimited amounts of equity, the shareholder must give up more than just the right to vote for the manager—rather, the non-voting member must give up all governance rights consistent with historical limited partnership status. Anyone retaining governance rights beyond these limited rights would be treated as a voting member. This rule prevents a situation where the manager is stripped of most management rights, effectively making the LLC member-managed, but the foundation's right to vote for a placeholder manager is stripped away to comply with the excess business holdings rules. Again, this rule effectively addresses the control issue for purposes of Code Section 4943 but allows private foundations to invest in most third party alternative investment funds.

Of course, under this scenario, there is a statutory change to Code Section 4943(c)(3), so that Treasury's ability to promulgate regulations under that section is not limited to regulations "consistent in principle with" the corporate rules, utilizing profits and capital interests as an analog to voting and non-voting interests, respectively. Without that statutory change, Treasury is stuck using profits and capital as proxies for control for both partnerships and LLCs. In such a case, the danger lies primarily in giving capital interests (whether in partnerships or LLCs) excessive voting control. Thus, Treasury might look to the anti-abuse regulations of Section 704(e) for inspiration, which provide that the transferee of a transfer (by gift or purchase) of a capital interest in a capital-intensive partnership will be ignored as a partner for federal income tax purposes if the donor, directly or indirectly, retains control over the capital through other means.³⁰⁸ In the case of Code Section 4943, the issue might be reversed—that is, in lieu of stripping the capital interest of all governance rights so that the transferor did not relinquish dominion and control of the capital interest (as would happen under Code Section 704(e)), the profits interests are stripped of all governance

307. UNIF. LTD. P'SHIP ACT § 302 (2001) (amended 2013).

308. See Treas. Reg. § 1.704-1(e)(1)(iii) (as amended in 2013).

rights and given to the capital interests. In such a scenario, the capital interests would not be treated as transferred to the foundation but would be deemed to be retained by the original transferor.

While the application of such an anti-abuse rule would address the control issue inherent in evaluating an LLC under an economic standard, it could be argued that such a facts-and-circumstances rule does not give sufficient guidance to the foundation. However, the transfer of a naked capital interest imbued with excessive governance rights to a private foundation, with only 20% of the profits interest retained by disqualified persons with respect to the foundation, does not appear to be the type of transaction that would occur in the normal course. Rather, it would likely occur in the context of a family transfer. One might argue in retort that it is exactly the type of transaction that should be made difficult to undertake in order to avoid those “subtle forms” of self-dealing that Code Section 4943 was intended to capture.³⁰⁹

If the LLC checks the box as a corporation, then it would be allowed to have an unlimited amount of non-voting stock so long as non-disqualified persons owned less than 20% of the voting stock. In the corporate context, voting stock was determined on the basis of the ability to vote for the governing body of the corporation. As mentioned earlier, given the flexibility of governance inherent in the LLC form, the regular corporate rules that equated voting for a director with control are insufficient, especially in the case of a member-managed LLC where there are no directors. An LLC governed by its members looks more like a general partnership than a corporation for control purposes. Accordingly, the non-voting share rule should apply only to those LLCs that are governed primarily by a manager or board of managers. As described above, the regulations could provide a safe harbor that would recognize a class of membership interest that would be “non-voting” if they retained only those interests akin to limited partnership rights³¹⁰—even if the LLC were member managed or the LLC was not primarily governed by a board of managers. Again, this should give most

309. 1965 REPORT, *supra* note 1, at 7.

310. Alternatively, one could provide that the voting members in a manager-managed LLC would only have those powers set forth in the Uniform Limited Partnership Act (2001) (amended 2013) or those rights that are given to the members by default in the Revised Uniform Limited Liability Company Act (2006) (amended 2013), without regard to changes that might be made in the LLC’s articles of organization or operating agreement. This, however, seems to be much less of a bright-line test than the list of enumerated powers set forth in ULPA. Additionally, reference to default rules in an enabling statute would mean that the definition of voting might vary by jurisdiction, depending upon what changes a state made to the LLC enabling act when adopting it, which in turn could encourage foundation forum shopping and the unequal treatment of taxpayers.

foundations the flexibility to invest in alternative investments that are run by third party managers without violating the control mechanisms to be addressed by Code Section 4943.

V. RECOMMENDATION AND CONCLUSION

Much has happened since 1969 when Section 4943 was first enacted: LLCs arrived, the corporate tax rate is on par with the highest marginal individual income tax rates, and the check-the-box regime governs entity classification. Outside of law, foundation investing has turned away from old fiduciary ideas of permissible investments to prudent investment rules, total return investing, and allocations to alterative equity holdings.

Although the world has changed, the fundamental concerns expressed in the 1960s—preventing distraction by business opportunities and undue benefit to private parties while preserving flexibility to invest and innovate—remain relevant today, as evidenced by the fact that these themes appear in contemporaneous debate regarding social enterprise. Therefore, it seems appropriate to keep these considerations in mind even today while formulating amendments to Code Section 4943.

In the best of all worlds, Congress could amend Section 4943 to address all the changes that have occurred in the tax and investment world since its initial passage. Congress could include provisions that specifically provide for LLCs and, while it is at it, reconsider the manner in which Section 4943 approaches other pass-through entities, such as limited partnerships.

In lieu of Congressional action, Treasury can clarify by administrative action the manner in which it approaches the Section 4943 analysis for LLCs. Such a pronouncement would at least provide some direction for those private foundations with sophisticated investment portfolios for which the technical distinction may make significant difference. While such guidance would be better than nothing, it would not address the fundamental concerns raised by Congress in 1969 that remain relevant today: How much involvement in business activities is permissible? How can we allow foundations to invest wisely while ensuring that they remain appropriately focused on charitable endeavors?

A modified check-the-box approach to the application of Section 4943, as described in Part IV.C above, would provide appropriate guidance, administrative ease, and the flexibility to invest foundation assets in most third party investment opportunities in an appropriate

manner. While a pure check-the-box methodology runs the possibility of allowing too much involvement of a foundation in business activities, thus running afoul of Congressional intent as expressed in 1965, a modified method geared specifically at the issue of allocating governance rights in a manner to manipulate the statute could provide a sufficient curb on involvement in business governance as to prevent undue distraction. Moreover, it would follow the modern trend of allowing foundations to adopt business methodologies that further charitable purposes, while not ignoring the appropriate distinctions between business and charity altogether.

VI. APPENDIX

Text of 26 U.S.C. § 4943(c)(1), (2), and (3) (2012)

(c) Excess business holdings. For purposes of this section—

(1) In general. The term “excess business holdings” means, with respect to the holdings of any private foundation in any business enterprise, the amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation in such enterprise to be permitted holdings.

(2) Permitted holdings in a corporation

(A) In general. The permitted holdings of any private foundation in an incorporated business enterprise are—

(i) 20 percent of the voting stock, reduced by

(ii) the percentage of the voting stock owned by all disqualified persons.

In any case in which all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings.

(B) 35 percent rule where third person has effective control of enterprise.

If—

(i) the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and

(ii) it is established to the satisfaction of the Secretary that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the foundation,

then subparagraph (A) shall be applied by substituting 35 percent for 20 percent.

(C) 2 percent de minimis rule. A private foundation shall not be treated as having excess business holdings in any corporation in which it (together with all other private foundations which are described in section 4946(a)(1)(H)) owns not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock.

(3) Permitted holdings in partnerships, etc. The permitted holdings of a private foundation in any business enterprise which is not

incorporated shall be determined under regulations prescribed by the Secretary. Such regulations shall be consistent in principle with paragraphs (2) and (4), except that—

in the case of a partnership or joint venture, “profits interest” shall be substituted for “voting stock”, and “capital interest” shall be substituted for “nonvoting stock”,

in the case of a proprietorship, there shall be no permitted holdings, and

(C) in any other case, “beneficial interest” shall be substituted for “voting stock”.