PRIVATE FOUNDATIONS AS A FEDERALLY REGULATED INDUSTRY: TIME FOR A FRESH LOOK?*

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I. THE REGULATED INDUSTRY REGIME

One would not expect lawyers specializing in nonprofit and tax exemption matters to look upon America’s private foundations as a regulated industry. The matrix of code and regulations that rules the foundations emerged – at least explicitly – from concerns about obedience to fiduciary and charitable governance norms, rather than the conventional wellsprings for industry regulation. Thus, the foundations do not exhibit the hallmarks or the vices that typically beget industry regulation: they do not have the consumer-serving characteristics of airlines or hospitals, and they do not exhibit monopoly, scarcity, or other earmarks of "market failure" – or the negative health, safety, or environmental "externalities" – that call for public control.

* Despite its published form, this paper is still a work in progress, and comments, sweet or sour or in-between, will be most welcome. They can be sent to me in person, by mail (82 Edgehill Road, New Haven, CT. 06511), by phone (203-432-2698), by fax (203-432-0063) or e-mail (john.simon@yale.edu).

** In an age when transparency is valued, some modestly compulsive disclosures are in order. Although I make my living in the academy, I am a trustee and president of one fairly small foundation and a trustee of a much larger one. All foundations have to deal with the regulatory regime discussed in this paper, but neither of the foundations with which I am involved has encountered any special degree of difficulty in complying with any of the provisions of current law. In other words, I have no agenda to pursue on behalf of, or that would advance the particular interests of, either of these foundations.

I should also mention some advocacy: In 1969, representing only myself, I testified at both House and Senate hearings in opposition to the excess business holdings and appreciated property deductibility provisions contained in the pending legislation. Also in 1969, informally acting on behalf of the smaller of the foundations mentioned above, I attended meetings with Treasury officials to oppose the proposed ban on foundation voter registration activities and subsequently to help work out the final compromise provision on this issue, and I also met with Congressional staff members to explain program-related investing and urge favorable treatment of this philanthropic instrument.

On a less compulsive note, I wish to thank Harvey Dale for assiduous and consistently helpful commentary on a preliminary version of this draft. The usual exculpatory comments apply.

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Indeed, the foundations themselves do not regard themselves as an "industry." That term has connotations of commerce and the pursuit of profit that offend foundation persons (even those whose salaries were set with one eye on "comparable" business-sector executives). The Council on Foundations does not look on itself as a "trade association," and when this author once applied the word "cartel" to foundation conclaves that appeared to reach collective decisions on the goodness or badness of certain applicants, the reaction was one of bewilderment.

Whether or not the "industry" sobriquet fits the foundation world, and despite the strangeness of the regulated industry metaphor to members of the nonprofit bar, it is fitting that we examine the present legal treatment in regulated industry terms. The "regulated industry" term is used variably in the literature – sometimes to apply to rate-regulated industries (e.g., public utilities or railroads or natural gas production), sometimes to apply to industries where entry and/or exit are controlled (e.g., broadcasting or airlines), sometimes to apply to industries whose goods or services are inspected and monitored in order to protect the public from health or financial hazards (e.g., pharmaceuticals, banking). What is true of all these "regulated industry" usages, whether they refer to federal or state regulation, is that they deal with instances in which a number of actors have enough common characteristics to be subjected to a common regulatory regime – clearly the case for the country’s 45,000 foundations – and where that regime imposes a relatively intensive and/or extensive set of controls on the regulated actors. Consider then, in terms of intensivity or extensivity, the following controls imposed on foundations by the federal government:
A. A Highly Detailed Regulatory Corpus

The private foundation code, enacted by Congress largely in 1969, implemented by copious regulations, embraces not only the prohibitions set forth in sections 4941-4945 but also the section 4940 tax on investment income, the section 170(b)(1)(B) and section 170(e)(1)(B)(ii) restrictions on deductibility of gifts to foundations, the exemption application requirements of section 508(e), the termination tax of section 507(c) and the reporting and other disclosure provisions of sections 6033(c) and 6104(d). This thicket of rules is comparable to other regulatory regimes in its comprehensiveness. It controls central aspects of entry and exit and of the financial, managerial and even programmatic activities of foundations, as described below.

Entry And Exit Controls

With respect to entry, while nonprofits over a certain size that wish recognition of tax-exempt status (except churches) must comply with the requirement of filing a Form 1023, the entry hurdle is a little higher for foundations: they must file regardless of size. Another aspect of entry control is also in place: the federal requirement that each foundation’s state certificate of incorporation contain certain prohibitions (tracking code sections

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1 All references in this paper that simply set forth a section number (e.g., Sec. 170) refer to sections of the Internal Revenue Code of 1986, as amended.

All of the provisions just cited in the text apply to "nonoperating foundations" (roughly speaking, grant-making foundations). "Operating foundations" (roughly speaking, foundations that mainly operate their own programs rather than make grants (section 4942(i)(3)) are exempt from the deductibility restrictions (sections 170(b)(1)(A)(vii), (E)(i); section 170(e)(1)(B)(ii)) and the Sec. 4942 payout rules (section 4942(a)(1)). Since nonoperating foundations are vastly more numerous — and represent a vastly higher level of assets and expenditures — than operating foundations (The Foundation Center, Foundation Giving (1999), p.2, Table 1), references in this paper to "foundations" or "private foundations" will be to "nonoperating foundations," unless otherwise indicated.
4941-4945); this is not a difficult legal step – indeed, legislation in many states automatically inserts the mandated prohibitions into all certificates filed in those states – but it does reflect federal gatekeeping.

With respect to exit, the fearsome termination tax penalties of section 507(c) make it impossible for a foundation to pass away quietly in the night when its work is done. One can understand the evasive techniques section 507(c) seeks to combat; the fact remains that it represents an outgoing barrier more formidable than the entrance gate.

Financial Controls

**Output controls:** The mandatory payout rules of section 4942 set a floor on foundation grants. That floor is further elevated by the way the section 4940 investment income tax works. As Eugene Steuerle states, "The excise tax on income is increased [from 1 percent to 2 percent] if payout in any one year falls below the average for previous years. Therefore, extra giving in one year merely raises the base on which the adequacy of future payouts will be assessed." ²

**Price controls:** Here the controls are not imposed on prices charged by foundations (what would they be?), but on those paid by the suppliers of resources to foundations – i.e., the after-tax price paid by donors as the cost of contributing to foundations. Until recently, the after-tax price of a gift of appreciated property to a foundation (except a pass-through gift) greatly exceeded the price of giving the same property to a public charity; only basis could be deducted in the former case, compared to market value in the lat
ter. Even now, that price disparity applies to a significant class of contributions: gifts of appreciated property that is not "qualified appreciated stock," a term referring to publicly-traded stock that is a capital asset in the donor's hands and does not represent more than ten percent of the issuer's equity (sections 170(e)(1)(B)(2), 170(e)(5)). Moreover, contributions of any kind to a foundation are limited to a lower percentage of the donor's adjusted gross income than gifts to other charities (section 170(b)(1)(B)).

**Investment controls:** The investment practices and policies of foundations are shaped in important ways by (a) the general "jeopardizing investment" provisions of section 4944, which do not necessarily duplicate the investment standards of the state courts of equity in a foundation's home jurisdiction, and (b) the more particularized "excess business holdings" prohibitions of section 4943 (discussed later in Part II).

**Transactional controls:** Section 4941's self-dealing rules regulate the transactional activity between a foundation and its managers or related entities, as well as transactions between a foundation and certain government officials.

**Programmatic And Other Grantmaking Controls**

**Controls on "political" activity:** These rules (a) effectively prohibit grants to influence legislation (section 4945(e)), without the "insubstantiality" escape hatch or the safe-

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3 The original, 1969, basis limitation on gifts of appreciated property was modified, to remove that limitation in the case of "qualified appreciated stock," a number of times — on each occasion with a sunset clause — until, finally, the Tax and Trade Relief Extension Act of 1998 made the "qualified appreciated stock" exception permanent, effective for gifts made after June 30, 1998.
harbor election enjoyed by non-foundations (sections 501(c)(3), 501(h), 4911), and (b) limit a foundation's ability to support voter registration (section 4945(f)), while not imposing most of these limits on public charities.

Controls on grants to individuals: Section 4945 requires pre-grant clearance from the IRS of a foundation's criteria for travel or study grants to individuals.

Controls on grants to non-public charities: Foundations must comply with a special set of "expenditure responsibility" procedures to accompany grants to most entities that are not public charities (section 4945(h)).

In addition to this extensive set of controls, other hallmarks of industry regulation obtain in the foundation field:

B. A Specialized Regulatory Agency

While the IRS is not, of course, an agency that exclusively regulates foundations, the personnel of the Exempt Organizations Branch, and the agents and examiners they train, specialize in nonprofit matters; moreover, processing foundation applications and audits occupies a disproportionate amount of the time of this cadre of personnel (in part because the section 4940 tax is justified as an auditing fee for foundations).

C. Enforcement Measures

1. Penalty Taxes. The excise taxes imposed by sections 4941-4945 on foundations and their managers operate for all the world like the fines imposed by regulatory agencies
in other fields. The enactment of these penalty taxes/fines (for that is what they are) has spread to the world of public charities, where penalty taxes/fines are now in place for (a) violations of the lobbying ceilings that become operative if a charity files a section 501(h) election (section 4911); (b) engaging in certain forms of electoral activity (section 4955); (c) falling afoul of the recent "intermediate sanctions" legislation (section 4958). Reliance on penalty taxes/fines is, however, much more widespread in the regulation of foundations.

2. Triggering of State-Level Sanctions. As noted, section 508(e) requires that every foundation certificate include the prohibitions of sections 4941-4945, thus enabling the attorneys general and courts of every state to use state law sanctions to police this array of restrictions.

D. Detailed Reporting Requirements

Foundations are required to provide a higher level of reporting than other charities (compare Form 990 [public charities] with Form 990-PF [foundations]), and small foundations are not exempt from an annual reporting requirement, as are small public charities (section 6033(a)(2)).

E. Differentiated Treatment Targeted to Industry Subsets

Just as the airline subsectors are subjected to different levels and forms of regulation, so the foundation world has been disaggregated: operating foundations (defined in section 4942(j)(3)) are exempted from some of the provisions regulating non-operating
foundations; a newer (1984) breed, "exempt operating foundations" (defined in section 4940(d)(2)), is exempt from some other provisions; and certain split-interest trusts (per section 4947) are subject, in some cases, to all of the private foundation provisions, in other cases to only some of them.

What all of these provisions construct is what Justice Stephen Breyer has called the “large...governmental presence" that accompanies industry regulation. Moreover, even the avenues of escape from regulation resemble the exit patterns found in all or most other regulated industries. The legislative history and post-enactment history of the 1969 Tax Reform Act reveal three revered avenues of partial or total exit.

F. Avenues of Escape

1. Exemptions. Congress over the years, in "bullet" provisions and otherwise, has provided special relief to many foundations from a variety of provisions (e.g., the excess business holdings provision in the case of one foundation that owns a celebrated resort hotel) – form of ad hoc deregulation that may well be justified in individual cases but does not receive the public scrutiny it ought to have.

2. Avoidance or Evasion. I have used standard tax terminology to refer, respectively, to lawful and unlawful escape methods:

Avoidance: The use of section 509(a)(3) supporting organizations, community foundations, and donor-advised funds located within public charities, in order to preserve

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important measures of donor influence while avoiding private foundation treatment. In all three of these categories, organizations have marketed these advantages with varying degrees of bluntness.

**Evasion:** Unlawful tactics to defeat regulation. I was shocked a few years ago, after all the effort that went into the 1969 compromise that saved voter registration activity for foundations (section 4945(f)), to hear program officers of foundations in a certain large city boast about how they had gotten around the voter registration rules by giving technically non-earmarked grants to a local church for the clear purpose of getting out the vote for a favored local candidate. (I protested both on grounds of law obedience and prudence; they were asking for all kinds of trouble. It was not clear to me that they were listening. I have not seen much of this behavior; I hope it is rare.)

**3. Incremental Deregulation**

**Congressional level:** In the years following 1969, Congress reduced (subject to conditions referred to above) the tax on investment income; cut back on payout requirements by eliminating the net investment income test; improved the deductibility of property gifts to foundations (but not in the crucial case of closely held stock); provided longer redemption periods under the excess business holding rules (but not enough to remove the

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5 These mechanisms are discussed by Victoria Bjorklund in “Charitable Giving to a Private Foundation and the Alternatives, the Supporting Organization and the Donor-Advised Fund,” in N.Y.U. School of Law, Center on Philanthropy and the Law, Conference on Private Foundations Reconsidered (1999), which appears elsewhere in this issue. Robert Ferguson’s paper at the same conference, “Avoiding Private Foundation Status: Escape Routes Based on Operations and Income,” also in this issue, discusses other “escape routes” that use the foundation definitional rules to arrive in public-charity-land or at least in the demi-monde of operating-foundation-land.
disincentives referred to in Part III); and relaxed, quite modestly, the self-dealing provisions.\(^6\)

**Administrative level:** The Treasury and the Service have engaged in what I think is, for the most part, a sophisticated and enlightened approach to the issuance of regulations under the 1969 Act. Treasury implementation of the anti-lobbying and jeopardizing investment rules (sections 4945(e), 4944), for example, has provided a mild form of interpretive deregulation in these two areas (although the section 4944 regulations are marred by an internal contradiction\(^7\)). Moreover, the Service has generally been thoughtful and sensitive to the needs of the foundation community in its rulings.

This review of the classic earmarks of industry regulation (and escape from regulation) that are encountered in the foundation field compels us to look upon the world of private foundations as a regulated industry.\(^8\)

But why should any of this matter? "Who cares," to use the Gershwin refrain, if private foundations are a regulated industry? The answer is that those who form and those


\(^7\) Compare regs. sec. 53.4944-1(a)(2), third sentence (every investment to be appraised "taking into account the foundation's portfolio as a whole") with regs. sec. 53.49449(1)(b), Example (1) (appearing to ignore the "portfolio as a whole" approach).

\(^8\) In one respect, American foundations are more heavily regulated than their counterparts in other countries, where the legal treatment is much less dense and detailed (partly a consequence of the fact that these foreign charities receive far less favorable tax treatment). For reviews of foreign legal systems, see Lester Salamon, *The International Guide to Nonprofit Law* (1997) and Thomas Silk, ed., *Philanthropy and Law in Asia* (1999). In another respect, however, the foreign counterparts to American foundations — indeed, most other foreign charities — are more heavily regulated than U.S. entities because of the requirement of advance registration. Thus, "each country [in the Asia Pacific Region] uses some form of permission system..., requiring NPOs to overcome obstacles and restrictions before government approval is granted." Silk, *supra*, p. 20; see also Salamon, *supra*, p. 17.
who appraise public policy should care, because of the general implications of regulated industry status and because of the special implications of regulated industry status for the world of foundations.

Turning first to the general implications, a regulated industry is the object of an extraordinary assertion of governmental power. One does not have to be a conservative or libertarian foe of Big Government to view with caution the imposition of comprehensive and intensive state control over any segment of the social order. One does not have to carry the Tenth Amendment in one's breast pocket to believe that a significant burden of justification must be met in support of such an exercise of sovereignty by a government of limited powers. And as a corollary of this guarded approach, it follows that regulated industry status should be subject to reexamination (what the late Kingman Brewster, a former naval person, used to call a periodic "decommissioning review") from time to time. That process has, in fact, been followed in several industries (although without periodicity), resulting in extensive deregulation in the airline and telecommunications sectors, among others.

Private foundations, moreover, present a special case for caution when it comes to industry regulation – a case that invokes the uneasiness that many otherwise enthusiastic regulators feel when the subject is broadcast and cable television. In one way or another, most foundations engage in the traffic of ideas: they explore – at retail or wholesale, locally or nationally – new ideas in science, education, social services, religion, the arts, or they seek to restore and preserve old beliefs and values. It has been argued, plausibly in my view, that the entire nonprofit sector – or at least the 501(c)(3) segment of it – engages in such traffic, invoking First Amendment (or First Amendment-like) arguments in support
of freedom of action for charitable organizations. These arguments apply with special force to the foundation sub-segment of the nonprofit sector, where the absence of constituent governance permits the flexibility and leeway that cause foundation resources to be dubbed as the "risk capital" of philanthropy. "In these ways," the 1965 Treasury Department Report on Private Foundations stated, "foundations have enriched and strengthened the pluralism of our social order."  

In some respects, as noted in Part III, the regulation of the foundation industry impinges directly on grantmaking autonomy. The sanctions on lobbying, referred to above, provide a salient example; indeed, they suggest substantial First Amendment infirmities. The voter registration and individual grant restrictions also affect grantmaking freedom, although with less immediate First Amendment implications.  

Even were there no specific grantmaking controls, however, there would be cause for special concern about regulated industry status for foundations. Broad spectrum government regulation of organizations that deal in ideas may inhibit innovation and experimentation because of "slippery slope" fears, whether well-founded or not. Following the passage of the 1969 Tax Reform Act, one heard, in foundation conclaves, a good deal of "don't rock the boat" counseling.  

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Consequently, there are both a general case and a special case for reexamining the regulated industry condition of private foundations. When to launch such a reappraisal? Y2K is not a useful trigger; the approaching millennium is already too heavily booked with other forms of orotund soul-searching. But a convenient anniversary, one that speaks modestly of decennia rather than millennia, is at hand: the National Center of Philanthropy and the Law Conference on Private Foundations Reconsidered took place in the month marking the 30th birthday of the 1969 Tax Reform Act. In that anniversary spirit, this paper seeks to start the review process by putting on the table some of the issues that a full-scale reappraisal must confront. In so doing, I mean to raise dilemmas that should be considered as part of the reexamination, not to resolve them. In order to pose these issues with some degree of sharpness (and a minimum of boredom), what may seem to be a prosecutorial edge will sometimes intrude. At times it will seem that prejudgments have been made. The truth is that I have not come to rest on these issues. A further truth is that I do not have the slightest scintilla of a doubt that

[t]he for-profit and not-for-profit sectors...need governmental regulation and enforcement at some level, simply to assure everyone's maximum freedom to compete and cooperate in achieving their view of the public good to the fullest degree, protected from the actions of those who know no public good but their own aggrandizement.12

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12 Joel L. Fleishman, “Not-for-Profit Organizations and the Need for Regulatory Reform”, in Charles T. Clotfelter and Thomas Ehrlich, eds., Philanthropy and the Nonprofit Sector in a Changing America (1999), pp. 172, 177 (suggesting that the nonprofit sector's freedom and voluntariness are advanced "when government exercises its power with a light hand...").
Moreover, I do not believe that the current regulatory regime is malevolent or totalitarian, a point that will reappear. Nor does it appear that failure to deregulate, or even failure to conduct a full-scale reappraisal, will cause "Gibraltar [to] tumble" (Gershwin again) – although, as I suggest later, what is at stake is far from trivial.

One response to this call for reexamination has been the old refrain: "If it ain't broke, don't fix it." That nostrum is only applicable once one has determined that nothing is broke (and, in this field, there are various possible definitions of brokenness). To those who think that there is not even a prima facie showing of breakage, I can only ask forebearance – and further reading – before making this preemptive judgment.

There are some who believe that, in any case, legislative tinkering should be approached with great caution: In the interest of stability, or to honor reliance by affected parties, a presumption of rightness should attach to existing laws; the ex ante examination should be tougher than the ex post. A related concern is that re-doing a piece of legislation, even in the search for simplification, is bound to make for complexity and confusion (which perhaps explains the old Tax Bar refrain: "the only good tax is an old tax").

Even accepting the argument for amber lights, the case at least for reexamination seems sound and reasonably strong. And in parsing the issues that deserve such reexamination, we find that they fall into two, inevitably overlapping categories, referred to here, in shorthand, as principle and practice. "Principle" refers to the explanation of and justification for the present regulatory scheme. "Practice" refers to the outcomes of that scheme – the impacts on the foundation world and, in turn, the larger society.
II. APPRAISING FOUNDATION REGULATION – IN PRINCIPLE

Reexamination of the present regulatory scheme "in principle" embraces two questions: What is the overall rationale for conferring regulated industry status on private foundations? How do the specific components of the present regulatory scheme comport with the norms that should characterize the regulatory process?

A. The Overall Rationale

The difficulty with examining the rationale for the regulation of the foundation industry is that none is available. It does not appear that the Congress or its tax-writing committees or the investigating committees (Cox in 1952-1953, Reece in 1953-1954 and Patman in the early 1960s\(^\text{13}\)) or the Treasury Department (in its 1965 report) thought in regulated industry terms. Instead, the present scheme appears to represent a "just grewed" accumulation: a congeries of specific remedies for specific grievances.

These grievances, from very different quarters and of very different types, amounted to a state of siege against the foundations in the 1950s and 1960s. The attacks throughout the 1960s came from all sides. They came from the right, echoing the Reece committee's 1954 indictment of the foundations as seed-beds of "moral relativity," "collectivism," and other isms, including "empiricism."\(^\text{14}\) And attacks came from the populist left – from Congressman Wright Patman of Texas, accusing the big foundations of elitist

\(^{13}\) These reports are briefly summarized in Edie, “Congress and Foundations”, supra note 6.

\(^{14}\) Id. at 48-49.
grantmaking and a cartel-like grab for power over the American economy,\textsuperscript{15} and from the elder Senator Albert Gore of Tennessee, who likened the power of "unaccountable" foundations to that of the 16\textsuperscript{th} century English churches.\textsuperscript{16}

The siege came also from teacher organizations, angry at the Ford Foundation's school decentralization efforts, and from members of Congress offended by certain episodes: the use of foundation money by Frederick Richmond to try to unseat the powerful Congressman John Rooney, as well as the Ford Foundation grants that gave unusual rehabilitative help to the aides of the murdered Robert Kennedy.\textsuperscript{17} Other attacks had origins in racial conflict: an unreconstructed George Wallace complaining about those "pointy-headed" foundation people in New York "looking down on" the people of the South, and apparently some Southerners upset about foundation voter registration activity.\textsuperscript{18} Even academics were offended: Jacques Barzun complained that foundations "weakened the intellectual and perhaps the moral fiber of men and institutions."\textsuperscript{19}

Sharply distinguished from all these political and ideological foes, the Treasury Department issued a 1965 report that paid tribute to the social value of foundations but voiced a series of concerns about fiscal and fiduciary abuses – self-dealing, insufficient


\textsuperscript{18} Simon, The Regulation of American Foundations, supra note 16, p. 244.

yield and payout, shoddy or corrupt investment practices, ownership of controlling corporate interests – as well as objections to donor control of foundations. The Treasury presented no data indicating that the fiscal-fiduciary abuses infected more than a small percentage of foundations, but it gave colorful and dramatic examples to buttress its case. On the other hand, as Thomas Troyer has noted,

Unlike the law that emerged from Congress in 1969, Treasury’s recommendations included no tax on foundation income, would have set the payout percentage at 3 to 3.5 percent [as compared to 6 percent as enacted, and 5 percent now], proposed no intrusion into foundations’ programmatic affairs, and suggested no differentiation between private foundations and public charities in the charitable deduction allowed for gifts of long-term capital gain property.

Reaching beyond the Treasury’s 1965 recommendations (but not dealing with the donor control proposal), Congress responded legislatively to most of the grievances mentioned above. Each one led to a provision in the Tax Reform Act – one of the specific prohibitions set forth in the sub-code of penalizable activity (sections 4941-4945) – or to the reporting requirements (sections 6033(c), 6014(d)). It was not clear what grievance explained the new provision denying market-value deductibility to appreciated-property gifts (section 170(e)(1)(B)(ii)), for, as noted, the Treasury had not recommended it and

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20 Treasury Department Report, supra note 10.

none of the committee reports bothered to explain it. A careful study by Eugene Steuerle and Martin Sullivan of this provision – and of the rule imposing a lower percentage-of-income limit on gifts to foundations than on gifts to public charities (section 170(b)(1)(B)) – found no plausible rationale for either of them, as a matter of either abuse-correction or obedience to other concerns about foundations.22

If, without Congress's help, we tried to arrive at a rationale for regulated industry status, what would it be? As noted at the outset, foundations do not exhibit the conventional attributes that beget industry regulation, such as monopoly or consumer safety factors. Could there be other rationales for such regulation, broader than the specific complaints listed earlier – i.e., a more general angst about foundations in general? In other words, if there was a more general subtext for what Congress did in 1969, justifying a broad assertion of regulatory power, what was it? Based on hints (they are not more than that) from pre- or post-1969 congressional reports and from the 1965 Treasury Report, there appear to be five candidates for such a subtext:

1. **Quantitative concerns.** Here the lament is that a dollar given to a foundation produces a direct charitable benefit that is too little and too late compared to a dollar given to a public charity.

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Too little: The yields from foundation endowments – or at least the payout from those yields – were said to be inferior to those of other charitable endowments.

Too late: As the Joint Committee on Taxation stated in 1984 (not at the time of the 1969 Act), "Because as a general rule public charities and operating foundations directly carry out charitable functions and programs, expend charitable donations more promptly..., the Congress concluded that a tax preference for contributions to public charities and operating foundations continues to be appropriate." (Hence, the percentage-of-income limits should continue to favor public charities.)

2. Qualitative concerns. Here we encounter the charge that foundations have dealt with peripheral problems, with matters of concern only to intellectual elites – i.e., that the foundations tended to the "the leisure of the theory class." (Patman, in the early 1960s, was especially scornful of grants made by the Bollingen Foundation for "using tax-free dollars to finance...exotic" research into the "origin and significance of medieval tombstones in Bosnia and Herzegovina," rather than "Pittsburgh poverty.")

3. Accountability concerns. A lack of "accountability" to the citizenry was the lament of several critics, including, as noted earlier, the late Senator Gore Sr.; the word "majoritarian" might fit this subtext somewhat better. The 1984 Joint Committee report quoted above, in the place where there is an elision, added, as a

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23 Quoted in id., p. 775.
reason for a more favorable percentage-of-income cap on gifts to public charities, the fact that public charities have "public involvement, support and supervision." This concern was mentioned also in the 1969 committee reports to the same purpose, although not relied upon or even emphasized as a basis for the overall regulatory scheme. A related "accountability" point was made by the committees when "explaining the rationale behind the new category of organization described in section 509(a)(2)"; the committee reports state that the requirements that such an organization receive at least 1/3 of its support from public contributions and gross receipts and not more than 1/3 of such support from gross investment income were "...designed to insure that the organization is responsive to the needs of the public."n25

4. Dynastic concerns. From time to time, congressional or academic critics of foundations have focused on the fact that the foundation controlled by a donor and his or her family can serve as the vehicle for the dynastic control over wealth – a form of control, it is argued, inconsistent with egalitarian norms of the federal tax system. This issue was addressed (with legislative proposals) in the 1965 Treasury Report, although the Treasury did not pursue the issue or the proposals in its 1969 recommendations to Congress, and the 1969 committee reports do not mention it. (An important subset of the dynasty issue – but not a problem broad enough to serve as a subtext for general regulation of foundations – involves the use of foun


25 Ferguson, “Avoiding Private Foundation Status,” supra note 5, p. 32.
dations to assist perpetuation of dynastic corporate control, referred to in Part II, below.)

5. **Wealth concerns.** This is the most elusive of the five possible subtexts, but it is difficult to ignore the probability that foundations, more than other American institutions, are identified as pockets of great personal wealth. Here riches lie, and what may be worse, here they are gratuitously dispensed. This wealth, moreover, is not buffered by conventional constituencies – no voters or customers, no alumni, students, parishioners, patients. The absence of such a constituency makes the foundations unique among American institutions for their freedom of action but, at the same time, especially susceptible to attack. Even the donees are difficult to mobilize in support of their patrons; dependency generates attitudes much more complicated than simple gratitude. (The late Robert Maynard Hutchins, while he was at the Ford Foundation, was once heard to lament, "Why do they hate us? We didn't even give them a grant!")

It would be difficult to justify positive federal regulation of foundations – prohibitory legislation backed up with injunctive relief or criminal sanctions – on the basis of the alternative subtexts just outlined. It would require a strenuous application of the Commerce Clause or the General Welfare Clause – more strenuous than present day jurisprudence seems to permit – to justify such positive legislation based on these laments.

Two other alternate rationales for positive legislation of foundations have been advanced. In unpublished N.Y.U. conference discussions, it was said that federal legislative jurisdiction followed from the fact of the deductions afforded to those who create foun
dations (or at least those who did so following the passage of the 16th Amendment); positive legislation was needed to make sure that charitable purposes and activities that justified a deduction were pursued by the recipient organization in post-deduction years. One difficulty with this proposition is that it opens the door to legislative control in many areas of our national life to which tax deductions attach: medical treatment, purchase and maintenance of primary residences, income-generating expenses of various kinds, divorce arrangements, not to speak of the world of business deductions – and, of course, the regulation of all non-foundation charitable activity funded by deductible gifts. In each of these cases, the fact of a deductible expenditure by a single taxpayer in year one would justify permanent regulation of the object of that expenditure.

A closely-related rationale was advanced by the Treasury in its 1965 Report, when it stated, "Since the federal tax laws have played a significant part in the growth of foundations, an unavoidable responsibility rests on the federal government to do what it reasonably can to insure that these organizations operate in a manner conducive to the fulfillment of their purposes." This jurisdictional theory would have strange consequences. "Would this notion of parental responsibility," I asked in 1965, "lead, for example, to federal regulation of the administration of Cornell University or other land-grant colleges initially spawned by federal subvention?" It may be assumed that this rationale is not presently in play; as far as I know, it has not been heard from since 1965. Were this argument to be deployed again, it would lead us into a dense tax-theory thicket. The Treas

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ury’s 1965 proposition appears to assume the existence of federal subsidy through the tax system. The assumption that exemption and deductibility represent a "subsidy," while unhesitatingly assumed by Chief Justice Rehnquist in the *Taxation Without Representation case*, has been seriously challenged – with respect to exemption, with respect to income tax deductibility, with respect to estate tax deductibility, and with respect to state property tax exemption. These challenges are all based on the notion that these forms of charitable exemption and deductibility reflect accurate and internally consistent definitions of the tax base, rather than government largesse. Without pausing here to summarize the subsidy vs. tax-base-defining arguments, I note that this issue haunts any effort to justify a regulatory regime on the ground that it is a concomitant of government subsidy.

The legislative treatment of private foundations sidesteps these issues of federal legislative power the old-fashioned way: through taxation. The way this industry is regulated is not through the use of administrative or judicial injunctive power or criminal

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sanctions – the typical apparatus of "positive" regulatory law – but largely through a battery of what are called "excise taxes." The taxing power is the last refuge of a legislature unsure of its jurisdiction. Indeed, the resort to the taxing power repels all jurisdictional assaults, as Justice Frankfurter bitterly complained when dissenting from the Supreme Court's decision in the Kahriger gambling tax case,34 a decision holding, in effect, that taxation trumps federalist cavils. Justice Frankfurter wrote:

[W]hen oblique use is made of the taxing power as to matters which substantively are not within the powers delegated to Congress, the Court cannot shut its eyes to what is obviously, because designedly, an attempt to control conduct which the Constitution left to the responsibility of the States, merely because Congress wrapped the legislation in the verbal cellophane of a revenue measure.35

To those, like Frankfurter, who question the alchemy of the taxing power, converting a striking exercise of federal muscle into a banal revenue measure, the judicial response mimics the James Thurber character who described his answer to an inquisitive child: "Shut up,' I explained."

Putting aside these perhaps antiquated concerns about legislative power, the five "subtext" candidates mentioned above – five alternative rationales for regulated industry treatment – suffer from two other deficiencies. First, none of these rationales was offered as an overall explanation for the broad-scale regulatory regime that was enacted. Second,

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35 Id. At 38.
each of these subtext propositions is sufficiently rebuttable (if not refutable) to be problematic. Thus:

1. The quantitative concern of "too little" was not supported empirically, for foundations as a whole, by the available data even in 1969, before the payout rule took hold. And the "too late" concern tended to overlook the fact that many gifts to public charities – especially major gifts comparable to those going to foundations – become part of the endowment funds of the university, church, museum, or other recipient institution (either because the donor so directs or because of institutional policy); a dollar of endowment income given away by a foundation can produce a direct public benefit just about as soon as a dollar of endowment income spent by a public charity. Robert Ferguson states, "There's no particularly appealing reason to think that an organization that obtains its funding from broad public sources will, for that reason alone, expend its funds for programs of direct public benefit any more than quickly than a charity that obtains its funding from a small number of private donors."

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38 Robert Ferguson notes that “[m]useums and public libraries engaged in capital fund drives are unlikely to expend any of the contributions they are able to raise; nor is there reason to believe that the additional investment income earned by their enhanced endowments is more likely to be applied to charitable expenditures than to reduce future years’ fund-raising goals.” Ferguson, “Avoiding Private Foundation Status,” supra note 5, p.46.

39 Ibid.
2. The "qualitative" concern is surely too soft and subjective to be a basis for regulated industry status. Every example of a Bosnia-Herzegovina tombstones study grant can be countered by a grant that produced miracle rice or cured polio. The inquiry is not productive.

3. The "accountability" concern must come to terms with the "hard fact that [the goal of unorthodox or idiosyncratic experimentation and innovation] is usually irreconcilable with ongoing constituent control."[40] "In other words, if private foundations, as the Treasury wrote in 1965, have 'enriched...the pluralism of our social order,' it is precisely because the foundations are private, freed from constituent controls that would provide 'accountability.'"[41] Moreover, that part of the "accountability" complaint that seeks to insure that a charity is "responsive to the needs of the public"[42] has a logical flaw; as Robert Ferguson states, "To maintain that a broad contribution base will result in the organization's being responsive to the needs of its charitable constituents is a non sequitur."[43]

4. The "dynastic" concern is one that needs more unpacking than it can receive here. In an essay on this topic in 1978,[44] I argued that the foundation-dynasty

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41 Id., p.83.

42 See text at note 25, supra.

43 Ferguson, “Avoiding Foundation Status,” supra note 5, p. 47.

phenomenon was a subset of the larger dynastic effect that attached generally to the charitable contribution deduction under the income and estate taxes. The essay concluded that, although the case was not an "easy" one, the charitable deduction was defensible when judged either by principles of progressive taxation or by standards of legislative fairness and equity.

5. The "wealth" resentment may explain a good deal of congressional or popular opposition to foundations. But it surely cannot serve as a reasoned explanation for regulation.

The fact that we have not uncovered a robust rationale for regulated industry status of foundations does not mean that one cannot be formulated. It does suggest that this task – the search for a convincing theory of regulation – remains to be done as part of an overall reexamination.

B. Examining Major Components

We turn to a disaggregated approach to the "in principle" inquiry: looking at the rationales for specific components of the regulatory apparatus. How do these regulatory components comply with certain norms that characterize, or should characterize, the regulatory process? In the interest of parsimony (see next paragraph), I take the liberty of simply asserting these norms, rather than justifying each one in terms of legislative practice.
or democratic theory, with the hope that they will strike the reader as self-evident or at least having the scent of common sense.45

**Parsimony.** Do not regulate more heavily, do not cut more deeply, than is necessary. Parsimony is not to be confused with simplicity, which is unattainable in tax legislation.

**Flexibility.** Allow some room for the regulators to deal with hard cases, to avoid outcomes that do not serve the underlying purposes of the legislation.

**Federalism.** Remember that outside Washington there are 50 American sovereignties, all of which have a regulatory function – particularly in the field of fiduciary duty – as to which courts of equity were dedicated long before there was an Internal Revenue Code. (Federalist issues were implicated, a few pages earlier, in our general discussion of federal legislative power. Here, we refer to questions of federalism in a somewhat narrower context: as they arise when considering the fiduciary-policing aspects of foundation regulation.)

**Evenhandedness.** Consider whether the regulation provides similar treatment for similarly-situated persons or groups.

**Circumspection.** Literally, look about before acting. That is to say, use peripheral vision to consider the side-effects of regulation, the possible impact on other values and traditions.

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45 Some of the analysis set forth in this section and in Part III of this paper, and some of the language in which this analysis is expressed, also appear in an earlier article of mine, *The Regulation of American Foundations: Looking Backward at the Tax Reform Act of 1969*, 6:3 Voluntas 243 (1995). The material in this paper, however, has been very extensively revised and expanded since the Voluntas article appeared.
Let us take a preliminary sounding of the extent to which these norms are well respected in the current regulatory pattern. First, parsimony. Parsimony appears to be slighted in the attempt to deal with the problem of foundation-donor control of business enterprises: the excess business holdings provision (section 4943). Of the three congressional objections to this phenomenon, the two that appeared to be plausible—ineffective yield and unfair competition—could effectively be handled by other provisions of the 1969 Act itself and, in case further assurance was needed, by other approaches I suggested in 1969 testimony before the House and Senate committees and expanded in a 1983 congressional presentation. That presentation, with apologies to already overburdened readers and with acknowledgment that some passages are obsolete, is appended to this paper. It is appended, in part, because it sets forth the pros and cons of the excess business holdings controversy more fully than this essay permits, and, in part, because it provides an example of a more parsimonious (but not necessarily simpler!) approach to the corporate control phenomenon than the radical surgery mandated by the current regulatory regime; depending on one's point of view, present law either effectively prohibits or robustly discourages the acquisition of excess business holdings.

46 Discussed in the Appendix to this paper.

47 In questioning, as I have here and in the Appendix, the excess business holdings provision, I do not mean to disparage the virtues of — indeed, the legal and fiscal necessity of — at least some significant degree of portfolio diversification. Although there may be something to the saying attributed to Andrew Carnegie, that one should put all one's eggs in one basket — "and watch the basket" — it is not an adage that can inform current practice. See Evelyn Brody, The Limits of Charity Fiduciary Law, 56 Md. L. Rev. 1400, 1487-90 (1998). In the Appendix (at note 6), however, I suggest that under special circumstances it may be possible to accept nondiversification.
(The "birthrate" consequences of this prohibition or discouragement are discussed below in Part III.)

Both parsimony and flexibility are given short shrift when it comes to the problem of self-dealing. Parsimony would call for less absolutist regulation than a total ban on most forms of self-dealing, prohibiting certain sale or lease transactions no matter how favorable to the foundation. Perhaps the pre-1969 courts, as the Treasury complained in 1965, were too lenient in administering the "arms length" standard generally followed when implementing the "operated exclusively for [charitable] purposes" language of section 501(c)(3). Yet there are techniques – such as the use of presumptive rules – that could toughen the judicial response. At the same time, a less rigorously prophylactic law would permit the IRS and the courts to use more flexibility in dealing with honorable forms of self-dealing. For there can be honor in self-dealing. One hesitates to quarrel with the Sermon on the Mount, but human experience tells us that a person can indeed "serve two masters," especially when it is done in the presence of mandatory sunshine.

The argument for strict per se rules is based not only on principled opposition to self-dealing, however, but also on two pragmatic assertions: First, that the IRS cannot effectively work with an "arms length" standard – a statement reiterated at the N.Y.U. conference but without much supporting evidence. Second, that foundation donors and managers will constantly "push the envelope" if there are looser rules. Of course, policing envelope-pushing is what regulators, state and federal, and the reviewing courts, are for. But that response, in turn, prompts the rebuttal, adverted to earlier and discussed further be

low, that the regulators – state and even federal\textsuperscript{49} and the courts as well – seriously under-
police.

This debate about the efficacy and fairness of prophylactic or per se rules is time
honored, with antecedents in the history of the common law-equity dichotomy: the choice
between inflexible but certain common law rules and the more plastic equity principles
that provide for accommodation to "local" circumstances. This debate, as it arises in the
modern context of foundation regulation, cannot be resolved in these pages; it deserves to
be part of any reappraisal.

Turning to the issue of federalism, it is evident that greater attention to this value
would also serve the causes of parsimony and flexibility. State courts of equity and attor-
neys-general are more accustomed to dealing with the policing of fiduciaries than is the
federal tax system. The state institutions have a wide range of remedial tools that are par-
simonious and flexible – surcharge, injunction, instructions, removal, denial of fees – as
compared to the tax code's reliance on penalty taxes and loss of exemption. Many of the
targets of present day foundation regulation – self-dealing, business ownership, payout
levels, and investment prudence – involve fiduciary problems that are the meat and drink
of state regulators.

It must be acknowledged, once more, that lack of staff and other resources, lack of
zeal or even interest, and possibly a fear of offending the local lords of the purse, plus re

\textsuperscript{49} "It is a conclusion of this paper that both generic regulatory agencies [IRS and state charities offices] are too weak, and, thus, a debate as to which ought to primarily be relied upon to assure nonprofit accountability is fatuous." Peter Swords, “Form 990 as a Tool for Nonprofit Accountability,” N.Y.U. School of Law, National Center on Philanthropy and the Law, Conference on Governance of Nonprofit Organizations: Standards and Enforcement (1997), p. 10.
strictive "standing" barriers, have created serious enforcement deficits. As far as state enforcement is concerned, is that situation hopeless? Joel Fleishman has recently recommended, as one of two preferred regulatory strategies (the first being a "joint nongovernmental accountability-enforcing organization" established by nonprofit sector umbrella groups), "a joint [nonprofit] sector governmental strategy" that would enlist the National Association of Attorneys General and the National Association of Charities Officials "for a national clearinghouse of information on abuses by tax-exempt organizations"; this clearinghouse would "investigate instances of such abuse...and work jointly with appropriate state and federal authorities to activate legal proceedings...." Greater reliance on "cyber-accountability" – through easier Internet access to, and understanding of, Forms 990 by "sleaze-busting" members of the public – is another possible route to better state enforcement, advanced by Peter Swords. Another state-oriented approach was one I recommended during a public debate with Treasury officials in about 1966: that the federal government itself take steps to help state attorneys-generals do their job more efficiently,


52 Fleishman, “Not-for-Profit Organizations and the Need for Regulatory Reform,” supra note 12, at 187. Mr. Fleishman recommends the creation of a new federal agency for policing and defending the not-for-profit sector, but calls it "a strategy of last report, which should be pursued only after it has become clear that, for whatever reason, the two prior strategies cannot be made to work." Ibid.

through improved information transmission and alerting mechanisms and possibly through a form of revenue-sharing to deliver needed resources to state regulators – and, thereafter, that the primary role be given to the states. One Treasury person – only slightly more dismissive than others who have recently taken (and who doubtless will take) the same position – said, "Professor Simon can't be serious!" I was serious, partly because I believed that a decent respect for principles of federalism should make us wary of relying on the national tax system to perform tasks that might, with help, be handled by state authorities.

Even without such extra assistance, it should be observed that it was the state attorney-general's office in New York that uncovered one of the worst foundation fiduciary scandals of modern times, and state regulators throughout the country who have taken the lead in policing the fiduciary abuses arising out of health industry conversion transactions. Of course, geographical unevenness cannot be wholly extirpated. But even within the IRS there can be disparate handling of similar cases. In any event, it would be difficult to argue that there is a need for nationally uniform treatment of foundation fiduciaries that is urgent enough to overcome federalism difficulties.


55 The discovery of a lawyer's removing $6-7 million from the Nate B. and Frances Spingold Foundation (assets: $12 million) over a period of six years, including $1.62 million in legal fees for the first six months of 1988. The withdrawals were disguised as public television grants on the IRS Forms 990-PF, but the New York Attorney General's office uncovered the truth – and sent the lawyer to jail. N.Y. Times, July 7, 1992, p. B3.

56 Although my federalism scruples did not gain many evident adherents at the N.Y.U. conference, there was some support for the notion of “turning back section 4944 to the states” – i.e., getting the IRS out of the policing of investment behavior.
The federal government's exercise of power in this fiduciary - fiscal area becomes even more problematic when we look at the congressional remedy adopted in 1969: not merely denial of exempt status but the imposition of several tiers of penalty-type excise taxes on foundations and/or their managers, as well as self-dealers. As already noted, this represents an assertion of full-fledged regulatory power over America's foundations – without a clear understanding of the rationale for federal jurisdiction.

While we have already noted that excise taxes are not ordinarily vulnerable to constitutional attack, one aspect of the 1969 Act represents an extraordinary use of the excise tax: to punish foundations for lobbying. Here, the vice may not be a breach of federal/state boundaries, but a breach of the First Amendment. In 1973 Thomas Troyer wrote a careful (and, for me, persuasive) analysis of the First Amendment implications of these particular penalty taxes. He strongly questioned their constitutionality, on the alternative grounds (a) that expression bearing on the governing process (e.g., to influence legislation) is speech of "governing importance" (Justice Brennan's language) and therefore entitled to "unqualified protection" from direct regulation, or (b) that under conventional "strict scrutiny" analysis, the extreme burden on foundation expression imposed by penalty taxes is not overcome by "a compelling government interest in preventing foundations from expressing legislative views...."57

We move from federalism issues to the norm of evenhandedness. One example of discrimination between foundations and other charities – the lobbying rules – has just been

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But this disparity in treatment characterizes virtually the entire regulatory framework. For example, two clear-cut examples of non-evenhandedness are, first, the tax on investment income, imposed only on foundations (section 4940), and, second, the provision that precludes deduction of the full market value of appreciated property other than "qualified appreciated stock," when given to a foundation for endowment purposes, while allowing a full deduction when the same property is given to a public charity for the same purposes. (As noted, not a word of explanation for the latter provision was provided by either the House or Senate Committee.)

In areas of industry regulation other than the foundation world, disparate treatment usually has an empirical basis. But as Boris Bittker wrote in 1973, there was no showing that the vices attributed to foundations could not be found elsewhere in the non-profit sector. In the absence of some empirical footing, one looks for another rationale for the disparity – a search that, to date, as I have argued, has not been fruitful. The continuation of such a search is, however, one of the major reasons for a thoroughgoing reappraisal of the foundations' regulated industry status.

This paper should not be misunderstood to argue that the remedy for disparity is to impose the foundation regulatory framework on the at least 1.5 million other American

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58 One fairly simple way of alleviating (although not entirely eliminating) the discrimination between foundations and public charities with respect to the lobbying restrictions was suggested by Robert Boisture at the N.Y.U. conference: permitting foundations to participate in the section 501(h) process, under which an electing organization can engage in legislative activity within quantitative ceilings established by section 4911, with penalty taxes imposed on those who exceed these ceilings. (Section 501(h)(4) currently excludes foundations from this process.)

nonprofit organizations as of 1996 or even on the 654,000 that had section 501(c)(3) status as of the same year.\textsuperscript{60} The point is, rather, that principles of evenhandedness are an appropriate source of concern about the current regulatory system.

Now, finally, the norm of circumspection, the consideration of regulatory side effects. These impacts can more conveniently be discussed under the next section, on private foundation regulation in practice, to which we now turn.

III. APPRAISING PRIVATE FOUNDATION
REGULATION – IN PRACTICE

There is, first, some good news. There are some obvious positive law-enforcement benefits from the regulatory enterprise now in place. It surely has deterred some, unmeasurable amount of fiscal or fiduciary misconduct. (We cannot infer very much, one way or the other, about deterred conduct from the very small level of penalty taxes collected under sections 4941-4945 – for example, $1.482 million for 1993, a total of $272,000 for the next four years.\textsuperscript{61}) Troyer has stated that the 1969 act "rid the field of abuses that undercut philanthropic goals and were, sooner or later, bound to precipitate congressional action."\textsuperscript{62} Another foundation watcher adds that the continuation of abuses

\textsuperscript{60} These numbers are from Elizabeth Boris, “The Nonprofit Sector in the 1990s,” in Charles T. Clotfelter and Thomas Ehrlich, eds., Philanthropy and the Nonprofit Sector in a Changing America (1999), pp. 1, 6. The same 1.5 million total figure – but as of 1991 – is set forth in William G. Bowen, Thomas I. Nygren, Sarah E. Turner and Elizabeth A. Duffy, The Charitable Nonprofits – An Analysis of Institutional Dynamics and Characteristics (1994), p. 4. I believe that the 1.5 million figure would be substantially higher if one included the small voluntary and social groups – bridge clubs, garden clubs, bowling leagues, etc. – that are, for various reasons, beneath the statistical radar. William Bowen et al. Also believe that the 1.5 million number could be “conceivably even larger,” although for different reasons. Id., pp.4, 16-17.


\textsuperscript{62} Troyer, “The Cataclysm of ’69,” supra note 21, p. 46.
would also have given foundation foes in the Executive Branch or Congress an excuse to act hostil\[...\]predispositions – and that the 1969 legislation precluded or minimized such aggression.

One may ask, however, compared to what? What other steps, short of regulated industry status, could have or would now have the curative effect attributed to the current federal presence? Some of the state-empowering measures referred to earlier? Or, at the federal level, more assiduous use of the tools available to the IRS for monitoring of all charities under existing law, coupled with improved advocacy to avoid slack judicial performance?\(^{63}\) Or, still at the federal level, a replacement of sunshine for regulation? In this connection, Justice Stephen Breyer has pointed to disclosure as one of the alternative techniques that "may be thought of as generally less restrictive ways of achieving regulation's ends."\(^{64}\) If this is an alternative, we may already have it in fair measure, with publicly accessible Forms 990-PF and exemption applications and the new GuideStar Web site available to disseminate much of this material. More "sunshine" could be made available, through the cyber-accountability measures recommended by Peter Swords and several other methods to improve disclosure that have been urged by Eugene Steuerle and Martin Sullivan.\(^{65}\) All of the alternatives just mentioned are candidates for consideration as part of a reexamination of regulated industry status.

\(^{63}\) As noted earlier, this idea was resisted at the N.Y.U. conference by some who said that the implementation of an arms-length standard for judging self-dealing is too difficult; “the Treasury can’t do it.” On this issue, we have a pair of canceling skepticisms.


Beyond abuse correction, it is also possible that full-scale regulation has helped to reassure the public about the integrity of the foundation world – even though there is room for doubt that the public at large has thought or cared very much about foundations or their probity. Indeed, my (admittedly hazy) recollection of public opinion surveys of 20 or 30 years ago is that the public knew as much about foundations as the citizens who were asked by the Candid Mike show a long time ago whether they had any scruples. "Never in my family," said one man; said another: "You want to go to Delancey Street for that."66

Finally, it has been argued that the 1969 regulation went beyond policing and public relations in its effects. Troyer has pointed to many improvements in the foundation culture over the past 30 years: increased professionalism, increased interchange and interaction among foundations, more varied and robust grantmaking, and improved structures for working constructively with government to curb abuses.

All that, of course, can hardly be attributed to the 1969 Act and its aftermath. But with its powerful stimulation for organization, mutual interchange and professionalism in the foundation world, its rules protecting private foundations from valid charges of abuse, and its many teachings about constructive government relations, the act generated more of the present situation than one might think. It struck a spark that has burned ever more brightly among foundations.67

66 One significant fringe benefit of current regulation is that it does give legislative blessing and encouragement, through Sec. 4944(c) and the committee reports, to "program-related-investing," an important and increasingly popular tool of modern philanthropy in a variety of fields.

I find myself agnostic both about a major post-1969 improvement in the health and
glor of the foundation field and about the chain of causation Mr. Troyer tentatively proffers. (In a caustic moment I think of the Treasury official who, at a bar meeting about ten years ago, said that foundations should look on the 1969 Act as "a blessing in disguise" – and (even though the contexts are monumentally different) of the time when Churchill was once told that for some complicated reason, Hitler was a "blessing in disguise." Churchill replied, "The disguise is perfect.")

But if neither agnostic nor caustic responses are appropriate, and Mr. Troyer, a wise and seasoned observer of the foundation scene, has this history right, that tells us about the debt the foundation world (and all of us) owe to the 1969 act. It does not tell us whether, 30 years later, we need to keep the regulated industry apparatus. To be a little crude about it, what has the 1969 Act done for the field lately? The Interstate Commerce Commission, after all, served crucial public purposes when it was established; it was abolished in 1995, with shrunken powers transferred to a successor agency. The point here, however, is not the need for abolition, but the need for reappraisal.

That reexamination must consider a number of impacts that represent, in one way or another, an apparent diversion of resources – diversions that each need scrutiny empirically (what is the direction and magnitude of the diversion?) and in public policy terms (is the diversion appropriate?) This inquiry can only be commenced in these pages, by taking a prefatory look at the following diversion candidates:
Diversion No. 1. It appears that the current regulatory regime has diverted some nontrivial amount of charitable giving from foundations to other public charities. One major cause of such diversion has been the combined operation of two "discriminatory" features previously mentioned: the "excess business holdings" rule relating to foundation holding of corporate control stock and the appreciated property deduction rule. (The latter rule, as noted above, no longer bars market-value deductibility of "qualified appreciated stock." The rule, however, continues to affect potential donors whose nest-egg takes the form of closely-held stock.) As of the time of the 1969 Act, approximately 80 percent of foundations with more than $10 million in assets had been endowed with corporate control stock or appreciated property or both. A study made by the Yale Program on Nonprofit Organizations and the Council on Foundations reported in 1987 that, of all foundations with more than $100 million in assets as of 1982, 50 percent had been formed with closely held stock, and 34 percent had been started with controlling-interest stock. Either type of gift would be likely to fall afoul of the "excess business holdings" rule, if made after October 1969, and, depending on timing, to violate the appreciated property deduction rule as well.

These data are suggestive of the impact of rules prohibiting or heavily discouraging the contribution of closely held stock and controlling-interest stock to foundations as compared to other charities. The impact is hard to quantify, but the Yale-Council on Foundations interviewers received strong testimony about it during the course of 135 interviews with wealthy donors or potential donors and with 100 lawyers and other advis

68 Elizabeth T. Boris, “Creation and Growth: A Survey of Private Foundations,” in Teresa Odendahl,
ers. The interviewers were told that the 1969 Act provisions did indeed induce donors to
pass these forms of wealth to other, more eligible receivers. (One lawyer reported that in
a single year he created three churches and two schools – or vice versa – just to receive
what would otherwise, in the hands of a foundation, be excess business holdings.) With
respect to the deductibility restriction, "a survey conducted prior to the 1969 Act indicated
that large charitable donors viewed the basis limitation as the provision that would have
the greatest negative impact on their future contributions to foundations."\(^{69}\) Eugene Steu-
erle and Martin Sullivan report "virtually uniform agreement that non-bequest giving to
private foundations dropped dramatically after 1969."\(^{70}\)

Because of the deductibility and excess business holdings provisions and other
complex rules thought to be minefields, and also because of the general nuisance of com-
plying with the new regulatory system, those interviewed in the Yale-Council study often
used alternative vehicles for charitable giving – not only schools and churches but commu-
nity foundations and other public charities, including "supporting organizations." The
irony is that these public charities are far less fully regulated than foundations under the
tax code – and, in the case of churches, are not even required to file information returns
(section 6033(a)(2)(A)(ii)).

**Diversion No. 2.** It seems inevitable that some resources were diverted away from
charity altogether. Discouraged by the disincentives militating against foundation crea

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\(^{70}\) Ibid., \textit{America’s Wealthy and the Future of Foundations} (1987), pp. 65, 71, 74. The percentages cited in the
text would be larger if all forms of appreciated property were included.
tion, some potential donors, we must assume, decided not to go ahead with major charitable gifts, especially where estate planning permitted them to achieve tax reduction goals without the use of a charitable disposition. The result: more for the children. In other cases the assets would be diverted not to the children but to other forms of non-charitable ownership – for example, a conglomerate acquirer or public investors to whom the asset-owner (or his or her estate) sells in order to raise cash for the estate tax.

**Diversion No. 3.** The tax on investment income, even though lowered in 1978 and 1984, has diverted charitable dollars to the U. S. Treasury in far greater amounts than any foundation audit expenses;\(^7^1\) the average yearly tax for the years 1993-1997 was $285 million.\(^7^2\) Steuerle and Sullivan point out:

> Although at each of these three junctures [1969 enactment and 1978 and 1984 modification] Congress has utilized this audit fee principle, revenue raised by the tax is not earmarked for administrative costs. Nor does it even roughly equal administrative costs.\(^7^3\)

**Diversion No. 4.** Harvey Dale has suggested two forms of diversion resulting from the payout rule (section 4942), even though, in the eyes of some, it is the least controversial of the foundation rules. With respect to the first form of diversion, Professor Dale

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70 Ibid. (emphasis in the original)
points out that, by compelling a certain level of disgorgement from foundation coffers, the payout rule takes funds that, left to its own devices, a foundation might reinvest in corpus and transfers these funds to a public charity that can use these funds to build up – or protect – its corpus. Assets thus are diverted to the custody of the endowed recipient from that of the endowed donor. Professor Dale then asks, which of these custodians of charitable resources is more likely to use them, in decades to come, in a way that responds to changing and urgent human needs? He has not definitively sought to answer that question, but he leans toward believing that a foundation – typically with fairly broad charter purposes and a wide mandate from its donor – might, over time, be legally and institutionally freer to shift gears than, say, a university or museum operating under strict purpose constraints imposed by charter and by donors. That leads Professor Dale to wonder whether this form of diversion is wise – and, therefore, whether there may be good reason to reduce the payout level by some considerable amount. The proposition is unlikely to win popular acclaim, but it is a fresh and important perspective.\(^\text{74}\)

**Diversion No. 5.** The second and somewhat related diversion Professor Dale ascribes to the payout rule is what he has called a diversion "favoring the present over the future." To quote from an informal memo he has written on this point:

> By forcing a 5 percent payout, whether or not good program opportunities present themselves to the particular foundation in question, funds go to the needs of the present that can now be found rather than being available for those of the

\(^{74}\) The language I have used is mine, not Professor Dale's, but I hope I have captured his point.
future. It can be shown that both annual and aggregate private foundation spending, over a long enough period of time, are greater with a reduced spend rate, i.e., more goes to charitable beneficiaries both annually and cumulatively (after some number of years) under a 4 percent spend rate than under a 5 percent spend rate.75

**Diversion No. 6.** Programmatic restrictions imposed as part of the regulatory system appear to cause resource diversion among grantees. Thus, foundations have an incentive to shift grantmaking away from individuals to organizations, because grants to individuals are procedurally restricted (section 4945(d)(3), 4945(g)). Moreover, foundations have an incentive to divert grants away from those organizations that do not qualify as public charities to those that do: schools, churches, hospitals or groups that can meet "public support" tests. The non-public charities, often newly-established operating groups that do not anticipate significant public support and therefore do not apply for an advance public charity ruling, are categorized as "operating foundations," over which the foundations have to exercise detailed "expenditure responsibility" under section 4945(h). In order to avoid the bother of expenditure responsibility, several grantmaking foundations – including some with ample capacity to handle this responsibility – have simply stated that they will not make grants to any operating foundations, thus excluding some of the tender shoots that need foundation help. While I believe that the fairly easy route to advance

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75 In support of the last sentence, Professor Dale cites DeMarche Associates, Inc., Spending Policies and Investment Planning for Foundations: A Structure for Determining a Foundation’s Asset Mix (1995) (a study sponsored and published by the Council on Foundations). A contrary approach, in terms of both methodology and policy conclusions, is presented in Perry Mehrling, Spending Policies for Foundations – The Case for Increased Grants Payout (1999) (published by the National Network of Grantmakers); the summation: “The conclusion is compelling: a minimum payout rate of 5 percent may have been right for 1981, but it is too low for today.”
public charity rulings (at least in the hands of competent advisers) makes this group of non-public charities smaller than in years past, the expenditure responsibility rule does constitute a potential source of diversion with adverse policy implications.

**Diversion No. 7.** Finally, there is the diversion of foundation resources to two forms of suppliers of services to foundations. First, there are the vendors of services needed to comply with the new regulatory requirements. For example, the Rockefeller Foundation, which had been paying normal commercial rent in Rockefeller Center, was forced by the section 4941 self-dealing rules to move, and it was an expensive move ($2 million was the "grapevine"-reported figure). A transaction like this one diverts charitable funds to moving companies, furniture stores, architects, plumbers: admirable actors but not the traditional objects of philanthropy. (Newspapers, too, used to sop up charitable funds by selling space to foundations announcing the availability of annual reports, but the advertising requirement has ended.) We must not omit lawyers and the accountants who find that full-scale regulation creates a splendid source of new business. Some of these professionals told the Yale-Council interview team that the 1969 Act encouraged them to enter the field of nonprofit practice. A second group of suppliers of services are the foundation staff members themselves; Peter Frumkin has described a huge increase in the "administrative bureaucracy" of foundations, which he attributes to managerial burdens.
caused by the new regulation and the desire to increase "legitimacy" through increased professionalization.\textsuperscript{76}

(Speaking of lawyers for another moment, they are, I think, partly responsible for the resource diversions I have mentioned, unnecessarily so in some cases. Many lawyers have told their clients that foundations are too much trouble – better use another vehicle. And some lawyers, I believe, have told foundation clients that expenditure responsibility is too perilous and should be eschewed by sticking to public charities. This is not a new trend in lawyer trepidation. Thirty-five years ago a member of one of America's flagship law firms told my Yale Law School class that he had advised one of America's flagship foundations that it could not give to Martin Luther King's Southern Christian Leadership Conference simply because it was not listed in what was then called the "blue book" of organizations to which deductible contributions can be made. And so the grant was not made. The students and I pointed out that foundations were not restricted to "blue book" grantees. His answer was roughly this: "I guess that's right, but it's too much hassle.")

**Birthrate Implications.** Returning to the list of resource diversions, they are not all equally serious, but they are all worth considering as part of a reappraisal of regulated industry status. Deserving special attention is the strong likelihood that these diversions – particularly those caused by the excess business holding rule and the appreciated property deduction rule – have contributed to a notable phenomenon on which the Council on

Foundations-Yale study focused: what appeared, at least for a time and perhaps even now for the largest foundations, to be a declining foundation birth rate. The most fecund decade was the 1950s, when there were established 2,046 foundations that in 1996-7 had more than $1 million in assets or made more than $100,000 in annual grants. In the 1960s the birthrate drop had begun: 1,922 such foundations were formed. In the 1970s the figure plunged to 1,160. The decline may have been temporary. According to the latest (1999) edition of Foundation Giving, published by The Foundation Center, in the 1980s the birth rate picked up for a time, declined in the late 1980s, increased again in the 1990s, dropped again in 1995; full data are not available since 1995. Certainly the absolute number of foundations has increased in this decade and the prior one, although the rate of formation has been below the rate for the 1950s and 1940s.77

At least two factors complicate efforts to untangle the effect of regulation on the birth rate. First, it is hard to establish the birthrate (new formations) as distinct from the growth in foundation numbers. The Foundation Center explains that growth in number of foundations may come from other than new formations – i.e., fewer terminations since 1984, an increase in the number of operating foundations actively making grants (and therefore entering the grantmaking lists), more accurate data on small entities, and the inclusion of 2,100 non-exempt charitable trusts in the IRS file and now counted as foundations.78 In the second place, it is exceedingly difficult to trace the impacts of regulation in

77 The information in this paragraph comes from The Foundation Center, *Foundation Giving* (1999), pp. 30, 32, 33.

78 *Id.*, pp. 31-32.
general – and the 1969 Act in particular – on the birthrate of foundations. Special transitory reasons (such as a wave of hospital conversions) may explain some of the growth. In addition, many foundations that came into existence in the 1970s and 1980s were created under pre-October 1969 wills, thus escaping the most stringent excess business holding rules; later testators possessed of such business holdings presumably will have less incentive to create foundations. Beyond these complications, there are many other variables that come into play. For example, one has to separate out such factors as these: stock market influences on giving patterns; the merger and acquisition movement's effect on the form of wealth held by potential donors (e.g., cash or public securities vs. excess business holdings); the checkered history of section 170(e)(5) (see supra note 3) and its interaction with changes in the Alternative Minimum Tax; the lead time between first round and second round (usually testamentary) giving to foundations (which may tell us something about the patterns of future giving to existing foundations); and more. It is my hope that someone will be able to sort out these factors (as part of the hoped-for reappraisal?), including an attempt to develop a crucial data set that is missing: the individual funding histories of a large sample of foundations established at different times.

I do want, however, to mention one interesting set of numbers, which comes from the 1999 edition of Foundation Giving (p. 30):
This table necessarily reflects two influences (apart from investment performance) on the number of foundations in various asset categories in each decade: birth-rate and what may be called "gift-rate" – the rate of giving to existing foundations. When one compares the 1960s to the 1970s to the 1980s in the "Total Foundations" column, it superficially seems that there has been a recovery in birth-rate cum gift-rate after the 1970s – i.e., that the apparent negative effects of the 1969 Act did not persist. (Of course that is what needs to be looked at more carefully, as stated above.) But now examine the "$100 million or more" column and notice the difference between it and all the lower-asset columns. That contrast is of considerable policy relevance, in my view, because, it is important to have a "number of doorbells on which grantmakers can ring – particularly the number of large scale sources of support for the introduction of new ideas and programs
or for the conservation of older values and traditions.\textsuperscript{79} In 1969 Senate testimony I emphasized the importance of foundations with "assets in excess of $10 million.... It is largely to these...foundations that individuals and organizations must turn to gain substantial foundation financing for new programs and approaches.\textsuperscript{80} Applying an inflation and market-growth multiplier to my $10 million figure of 30 years ago – and reckoning that even this figure was probably too low at the time (it was the only "high" asset category then available) – it would seem plausible now to be talking about the over-$100-million-in-assets foundations as the crucial "large scale sources of support" of the current era. And within that asset class, the birthrate/gift-rate data, as reflected in the above table, do not show a recovery from the 1970s decline.

An observation in Foundation Giving, on the other hand, suggests the likelihood that the infants of the 1980s may grow into bigger asset categories after they receive their major endowment at a later date. "Studies have shown that the largest independent foundations received their primary endowments about 18 years after creation, usually following the death of the principal founder and his/her spouse."\textsuperscript{81} Yet Elizabeth Boris's analysis of foundation formations from 1970 through 1982 showed that these foundations were much more likely than earlier foundations to have been formed by bequest (rather than


inter vivos)\(^{82}\) – suggesting that second-round testamentary funding may not be so likely for the foundations born in the 1980s.

On the birthrate story, therefore, the best answer that one can give at this stage is: Stay tuned! And the reason we should stay tuned – the reason one should be concerned about a declining birth rate among the biggest foundations – is the "doorbells" point. Here, in the philanthropic marketplace, as in the commercial marketplace, entry is a healthy – indeed, indispensable – phenomenon, and entry among the "heavy hitters" is perhaps especially important. The celebrated enlargement of the Bill and Melinda Gates and the David and Lucile Packard Foundations, now No. 1 and 2 in the United States in terms of assets,\(^{83}\) does not satisfy this requirement: there are a host of social needs, at home and abroad, for which these foundations do not represent potential doorbells. A robust pattern of entry requires more than a handful of colossi.

A drama that unfolded a month before the N.Y.U. conference suggests another way of looking at the "doorbells" story and the need for large-scale entry. The drama I have in mind is the controversy between Mayor Giuliani of New York and the Brooklyn Museum surrounding the "Sensation" exhibit. This is not the forum to rehearse the merits of this celebrated (and currently litigated) battle. But it will be observed that the causa belli is, in large part, the fact that the museum has been relying on the City of New York for one third of its annual operating budget – approximately $7 million a year – funding the Mayor wishes to end because "you don't have a right to government subsidy for desecrat


\(^{83}\) N.Y. Times, Sept. 12, 1999, pp. 1, 28.
The fact of government support gives rise to similar wars over government control in many other areas of our national life, not only in the arts (see the recurrent fights over National Endowment for the Arts funding criteria) but in health services (see the Hyde Amendment prohibition on use of federal health funding for abortions and the congressional refusal to pay UN dues so long as UN agencies engage in abortion-related activity) and in legal services (see the class-action and other restrictions on funding by the National Legal Services Corporation).

Those who oppose government string-tying (either ex post, as in the Brooklyn case, or ex ante, as in the UN case) may try to rein in mayors or legislators by persuasion, litigation, or legislation. But the problem is not likely to go away, for it arises out of deep and strong majoritarian imperatives, crudely but not inaccurately captured by Mayor Giuliani’s assertion that "most hard-working people do not want their tax dollars used to pay for this kind of thing.” The majoritarian pressure is discussed more fully and thoughtfully by James Douglas, who calls it the "categorical constraint" on government funding behavior and points to it as giving way to what he says is the "government failure" analogue to the economists' "market failure"; these "failures" refer to the inability of government, on the one hand, and markets, on the other hand, to provide goods or services to meet the full range of public demands, emanating from both majority and minority demanders. "Government failure" will always be with us – perhaps especially in a democracy.

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85 This is my approximate transcription of a recent television interview with Mayor Giuliani.
driven by majoritarian voices. Enter the nonprofit sector: As both James Douglas and Burton Weisbrod\textsuperscript{87} have argued, the "third sector" has as one of its rationales the delivery of goods or services in some circumstances of "government failure." In the United States, this role is perhaps more salient than in any other society; consider, for example, the minuscule part played by nongovernmental institutions in the fields of culture, "elite" higher education, scientific research and hospital care in all other countries of the world. Indeed, I wonder whether the huge share of the nation's business carried by voluntary organizations may be the defining characteristic of the American social order – even more than the rule of law and civil liberty and the role of private markets, which are fully embraced in some other lands.

\textit{Enter the Foundations:} They are the main, ongoing source of large-scale funding for America's nonprofit sector. They cannot begin to replace government funding in general. But they are and have been available to play a role, both domestically and to some extent internationally, in redressing the inevitable cases of "government failure." Voter registration in the South in the 1960s and funding for the Salk vaccine in the 1940s – in both cases following government refusal or inability to act – are two examples, out of many, that come to mind. In an era of reduced government spending on social programs and research, that role for the foundations will grow. Foundation funding will probably not relieve the Brooklyn Museum of substantial dependency on government support, but the "Sensation" saga does remind us of the importance of having alternative nongovern

mental "doorbells" – big ones and new ones – to turn to where reliance on government is impossible or unhealthy.

Resource scarcity will probably not be a reason for a lack of these "doorbells" in the years ahead. The enormous intergenerational wealth transfers that are predicted for the next several decades, even applying cautionary discounts, suggest the potentiality for large-scale entry into the foundation arena. The question is whether the present regulatory regime will stand in the way. That, as I have said, is a very difficult question to unravel. To repeat: stay tuned.

Non-"diversionary" impacts. This discussion of the impacts, "in practice," of the regulated industry status of foundations, concludes with a brief reference to a few of the non-"diversionary" impacts. To be specific, some features of the regulatory regime have behavioral consequences for foundations that do not qualify as "diversions":

Grantmaking Behavior: When it comes to legislatively-oriented grantmaking, foundations can neither take advantage of the "insubstantiality" defense available to public charities nor opt for a section 501(h) election, permitting certain levels of "safe harbor" legislative activity. These restrictions, coupled with the penalty taxes discussed earlier, not only constrain foundation grantmaking but appear, from a good deal of talk among foun

88 "Some Boston College researchers [Paul G. Schervish and John J. Havens] say that the widely cited estimate that $10.4 trillion of wealth will be transferred to younger generations over a half-century is far short of the likely amount. They estimate the wealth transfer will be $41 trillion to $136 trillion...The new figures suggest that charities, in particular, stand to benefit... [Mr. Schervish and Mr. Havens] estimated that between now and 2055 charities would receive bequests of $16 trillion to $53 trillion, measured in 1998 dollars, assuming that the estate tax remains unchanged." David Cay Johnston, "A Larger Legacy May Await Generations X, Y and Z," N.Y. Times, Oct. 20, 1999, p. C2.
dation personnel, to have an in terrorem effect even on conduct that, under the fairly helpful definitional exclusions (reg. section 53.4945-2(d)(1)-(4))\textsuperscript{89}, would pass muster with the IRS. Similarly, the complicated strictures on voter registration activity – and, again, the fear of penalty taxes – probably affect the willingness of foundations (not including the scofflaw examples mentioned in Part I, above) to support activities aimed at enlarging electoral participation.

**Managerial Behavior**: The prophylactic self-dealing prohibitions, discussed earlier (which do result in penalties even in cases where no harm is inflicted on the foundation\textsuperscript{90}), limit the administrative flexibility of foundation managers and probably discourage undoubtedly honorable financial or property transactions that are thought also to be legal – "but why take a chance?"\textsuperscript{91} The section 4944 "prudent investment" rules and regulations thereunder (briefly discussed earlier) may also have an impact on investment behavior, but probably more palpable is the impact of the payout rules on asset allocations. Thus, according to the DeMarche Associates study of foundation investment strategies, "Even to achieve real returns that will support payouts of only 5 percent will require more aggressive asset mixes than generally used by many foundations."\textsuperscript{92}

\textsuperscript{89} Or the regulation permitting non-earmarked grants to public charities that are used by the recipients for lobbying. Reg. Sec. 53.4945-2(a)(5).

\textsuperscript{90} See, e.g., Adams v. Commissioner, 70 T.C. 73 (1978).

\textsuperscript{91} What Section 4941 apparently does not discourage are foundation CEO salaries in the upper six figures, representing 10-20 times the salaries of the persons who run many of the charities funded by these foundations. But that is a (non-legal) story for another day and another conference.

IV. QUO VADIMUS?

I have no apocalyptic conclusion. As stated above, the present regulated industry regime for foundations is not evil or corrupt; it represents a great deal of hard work by bright and decent people; and it has been, in some respects, modestly helpful. Nor will the present regulatory system likely bring about the fate feared by the Psalmist: "If the foundations be destroyed, What can the righteous do?"\(^9\) But the regulatory regime was brought forth in the presence of siege; it presents difficult dilemmas both of principle and practice; its "entry" implications may impede the foundations' potential contribution to American pluralism; and it deserves, after three decades of experience, a fresh look.

\(^9\) Psalms 11. The Psalmist also wrote: "[A]ll the foundations of the earth are out of course." Psalms 82.
Hearings on Private Foundations
June 27-29, 1983

Statement of John G. Simon

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A Proposal for Resolving the Excess Business Holdings Dilemma

Introduction

As the hearings before the Subcommittee on Oversight have made quite clear, the phenomenon of what the law calls "excess business holdings" – roughly speaking, the ownership of corporate control stock by a foundation alone or in conjunction with certain related persons – presents the Congress with a dilemma. On the one hand, the Congress, speaking through its tax writing committees, expressed the view in 1969 that a foundation's participation in corporate control could impair the quantity and quality of its charitable performance and unfairly injure businesses competing with the controlled company. On the other hand, the statutory response to these problems, the divestiture requirement of section 4943 of the Internal Revenue Code, is viewed by the affected foundations and also by some other observers as a threat to the financial health and diversity of the foundation field, the larger charitable universe, and the small business sector of the economy. The purpose of my statement is to suggest a resolution of this dilemma that honors and accommodates both of these perspectives.

Concerns About the Impact of Section 4943

Turning first to the concerns about the impact of section 4943, they may be categorized as follows with some extrapolation on my part):

1. Section 4943 may result in disposition of foundation-owned corporate control stock at "fire sale" prices, causing two kinds of dislocation:
(a) If there is a windfall for the purchaser, at the foundation's expense, it represents a governmentally induced subsidy flowing from the (philanthropic) seller to the (non-philanthropic) buyer – a transfer of resources that the Congress could not have intended.

(b) "Fire sale" pricing could interfere with the efficiency of the capital market by preventing it from setting security prices in accordance with a bargain between a willing buyer and a willing seller. Such below-market security prices may attract capital to the "fire sale" transactions and thereby shrink the capital available to other small businesses seeking financing for start-up or expansion purposes.¹

2. Section 4943 may bring about a sale by the foundation of its corporate control stock to a chain or conglomerate purchases, with these results:

(a) The sale to a larger enterprise may reduce the diversity of corporate ownership; such an increase in concentration of ownership takes on extra meaning where it involves a newspaper or television station or other organ of communication.

(b) Transfer of the enterprise to non-family related ownership would appear to contravene the Congressional policy favoring retention of family business control and could also withdraw jobs and economic activity from a local community.

3. Section 4943 may discourage the flow of funds into the foundation field.

As stated by the Impediments Committee of the President's Task Force on Private

¹ It is not at all clear that extending the 5-year deadline for disposing of post-1969 receipts of excess business holdings – although a useful measure – will solve the “fire sale” problem. The seller remains an unwilling seller – a fact that probably affects the terms of trade.
Sector Initiatives (Rep. Conable, Chairman), "Faced with the prospect of a forced sale, many potential donors simply decide against making the gift of closely held stock to a foundation." In such event, the stock goes instead to a public charity, or remains within the family, or ends up in a public distribution or in a merger (depending, often, on estate planning imperatives). The potential dislocations are these:

(a) Such a shift in dispositive patterns would restrict the foundation "birth-rate," particularly among the larger foundations, where excess business holdings are proportionately more prevalent than among smaller foundations. Reduced entry into the foundation field would not only limit the fiscal capacity of the foundations at a time of increased reliance on private funding, but also shrink the number and variety of financing windows open to new ideas and programs – or to older values and traditions.

(b) If, for want of a foundation vehicle, the potential donor decides not to give the control stock to charity at all, total resources available to the nonprofit sector may be reduced.

(c) If the stock is given to a public charity instead of a foundation, there may be a loss in the government's ability to police the practices about which Congress was concerned, because of the reduced level of reporting, regulation and oversight of public charities as compared to foundations; indeed, churches are not even required to file any federal returns.

4. Section 4943 imposes a limitation on the allocational freedom of men and women whose wealth is tied up in an ongoing business, as compared to indi
viduals with more liquid forms of property; the former group will find their charitable options more circumscribed in the light of the restriction imposed by section 4943.

I have used the word "concerns" to characterize the points made above because with the possible exception of the fourth point, they are not grounded in a solid base of empirical information. A few foundations have testified about the difficulty they face in obtaining adequate value for their excess business holding or about the prospect of finding only a chain for a buyer, but the general situation has not been surveyed in any study of which I am aware. With respect to the third point, section 4943's impact on the flow of funds into the foundation field is one of the subjects of a major study now being launched by the Council on Foundation and the Yale Program on Non-Profit Organizations, but results will not be available for some time. (Even the trend in foundation "birth-rate" is a subject of some dispute: new Treasury data suggesting a recent spurt in foundation births appear to be inconsistent with other trend data and will require further examination and reconciliation.)

Despite the lack of general empirical support, the concerns –perceptions of risk – listed above are sufficiently plausible to deserve Congressional attention. Our general knowledge of distress-sale dynamics, of the tendency toward concentration of ownership (including media ownership), and of incentives and disincentives affecting charitable giving lend threshold credibility giving to each of these perceptions of risk. Moreover, these concerns all involve varieties of dislocation often associated with governmental intervention; our general knowledge tells us that there are often destabilizing side-effects that flow
from major intervention, governmental or otherwise, into any form of economic, political, biological or ecological system. For example, "radical" surgery, or the intrusion of man-made structures into a beach or a marsh or the toppling of a foreign regime, or an antitrust divestiture decree – each of these interventions can cause secondary but serious systemic dislocation. Of all the regulations imposed on the foundation "industry" by the Tax Reform Act of 1969, section 4943 – forcing divestiture of one important category of foundation property – most closely approximates a major intervention of the kind listed above.

Concerns About Foundation Participation In Corporate Control

Of course, not all major interventions are to be condemned because of their side effects. "Radical" surgery is often the only life-saving course; a beach or a marsh may have to be altered to serve vital public needs; foreign interventions receive widespread approval in crisis situations; and, in our case, too, the claimed dislocations attributed to section 4943 would be easier to accept if such intervention were the only way to meet the regulatory objectives. The question then becomes: Are there less drastic alternative avenues that one could pursue to achieve these objectives? Focusing on the congressional objectives in enacting section 4943, we encounter three concerns about foundation participation in corporate control, set forth in the following passage from the 1969 House Ways and Means Committee report:

1. Those who wish to use a foundation's stock holdings to retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes.
2. Even when the foundation attains a degree of independence from its major donor, there is a temptation for the foundation's managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties.

3. Where the charitable purposes predominate, the business may be run in a way which unfairly competes with other business. To deal with these problems, your committee has concluded it is desirable to limit the extent to which a business may be controlled by a private foundation. [H. Rept. No. 91-413, 1969-3 C.B. 200, 218; numbers in brackets have been added.]

As in the case of the concerns about the impact of section 4943, no comprehensive body of reasonably current data is available to support the three Congressional concerns about corporate control. The 1965 Treasury Department Report on Private Foundations recited several cases of no-dividend or low-dividend corporate control stock owned by foundations (pp. 33, 35, 39-40), but no overall data to compare the income productivity

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2 The Senate Report gave the same reasons, with immaterial language changes. S. Report No. 91-552, 1969-3 C.B. 423, 449-50. In his recent statement to the Subcommittee, Assistant Secretary Chapoton refers to a fourth concern (also expressed in the 1965 Treasury Department Report on Private Foundations):

The possibilities for conferring private benefit through a controlled business are numerous and in many cases very subtle. We do not believe it is possible to draft a statutory prohibition of all possible acts of self-dealing involving a foundation controlled business.

In the absence of any supporting examples, and in view of the failure of the Congressional committees to adopt this rationale in their 1969 reports, I will limit my comment on this point to two observations. First, foundations that invest in wholly independent, non-controlled companies will find themselves in roughly the same position – at the mercy of possible "subtle" manipulation by corporate insiders. It is a risk of corporate life that section 4943 cannot extirpate. Second, the "private benefit" that may accrue in subtle ways in a fact of charitable life as well. Consider the rewards that attends big giving – the publicity, the social or commercial acceptance, the deferential or preferential treatment from the donee institution, and the hope for salvation as well. As compared to these private benefits, are the benefits to which Mr. Chapoton refers significantly more objectionable? And, if so, are they sufficiently noxious to be subject to policing at the federal or state levels? Of course, contribution of control stock to a foundation often confers personal benefit by facilitating retention of family control over a business enterprise, but, as already noted, this form of private advantage is consistent with Congressional policy.
of control stock compared to other foundation holdings. The 1965 Treasury Report provided not even anecdotal evidence to support the claim of "neglect" of charitable duties because of preoccupation with business operations (p. 35); indeed, if one examines the past and present roster of foundations with excess business holdings – including those which presented testimony before the Subcommittee on Oversight – one encounters some of the most vigorous and committed grant-making institutions in the land. Finally, the 1965 Treasury Report offered only one illustration – ambiguous in its implications – to support the claim of competitive injury inflicted on businesses not owned by foundations (pp. 33-34); as Russell G. Mawby notes in his Statement, no new examples have been cited since 1969 despite the continued presence of excess business holdings under transition rules.

Yet, as in the case of the concerns about the impact of section 4943, the concerns about corporate control participation are plausible – or at least, two of them are. As to a third, the distraction claim, the logic escapes me, as it did Professor Boris I. Bittker, who wrote of the distraction rationale as follows:

The theory espoused by the Senate Finance Committee that foundation managers will devote their time to business rather than to their charitable responsi-

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3 Subsequently, aggregate Treasury data were released that pointed to very poor productivity of control stock, and I reported some rough calculations of my own that suggested average productivity, but, these contradictory estimates were based on data now more than 20 years old, not reflecting the impact of the 1969 legislation. The GAO report recently submitted to the Subcommittee on Oversight does not deal with rate of return on excess business holdings or from any other form of corporate control stock. It reports that balanced foundation portfolios earned a better return than portfolios tilted toward corporate stocks and bonds but (a) this finding was based solely on 1979 performance and, in any event (b) does not focus on control stock.
ibilities disregards the fact that the corporations in question require business management whether their stock is owned by foundations or by other investors. Conversely, the foundation's investments must be managed by its officers (or by advisors paid by the foundation), whether the portfolio consists of all the stock of three corporations or 10 percent of the stock of each of 30 corporations. No evidence is offered to sustain the view that the aggregate number of man-hours required to manage the corporations and to manage the foundation's portfolio is altered by the concentration of the foundation's holdings in a few corporations, and it is hard to believe that any such evidence could be found. It is equally difficult to comprehend why the foundation's charitable functions are more likely to be impaired by its trustees' desire a make "a success of the business" than by their desire to increase the yield of a diversified portfolio. Success in either endeavor will increase the funds available to finance the foundation's charitable functions. It should be noted, moreover, that the restriction imposed by section 4943 is in no way dependent on a showing that the same persons actually manage both the business and the foundation. The foundation's managers, officers and directors are, of course, ultimately responsible for deciding whether to hold or sell the foundation's investments, but this is equally true whether the portfolio is diversified or concentrated. [Bittker, "Should Foundations Be Third-Class Charities?" in Heimann, ed., The Future of Foundations (Prentice-Hall, Englewood Cliffs, N.J., 1973), pp. 151-52.]

With respect to the other two concerns – inadequate income and unfair competition – existing provisions of the Tax Reform Act of 1969 at least mitigate these feared abuses. The distribution requirement of section 4942, now pegged at 5 percent of asset
market value, although not requiring that each investment produce this return, exerts pressure on a foundation to insist that the business in which it holds control stock – even if it is a donor-related business – produce dividends at about this level.⁴ That pressure will not be felt where the control stock is not a major holding for the foundation and where, accordingly, the 5 percent can be earned from other investments, but in that case the foundation does not significantly suffer from the control stock’s low yield.) Any pressure on the controlled business to pay healthy dividends will also reduce the problem of unfair competition, for such dividend payments will make it difficult for the controlled business to expand with retained earnings at a rate faster than a competing firm owned by non-charitable shareholders. (Indeed, the dividend demands of such shareholders are far from fearsome; during the 10-year period ending December 30, 1982, total annual dividends paid by New York Stock Exchange companies on common and preferred stock, as a percentage of year-end market values, averaged 4.7 percent.) The unfair competition possibilities are further reduced by section 4941s self-dealing prohibitions, which preclude the foundation from lending to any business of which the foundation’s donor and other disqualified persons and their families own 35 percent of the stock.

State enforcement of fiduciary duties supplements these federal controls. As Norman Sugarman has pointed out in his statement to this Subcommittee, state activity in the charitable area has become more effective in recent years. And the tools are available: the ways in which state attorneys-general and state courts can induce a foundation to police the productivity of corporate control stock were described in a statement I submitted to

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⁴ Alternatively, the foundation might sell the stock to meet payout requirements but one suspects that most foundations will not wish to dispose of control stock for this purpose.
Although the existing federal and state enforcement mechanisms can address a good part of the low yield and unfair competition concerns (and although the distraction claim seems too gossamer to address), there may understandably be a perception of a residual risk, a feeling that further protection is needed than the present law provides.

(a) Under the inadequate return heading, there are two remaining problems.\(^5\) First, as Assistant Secretary Chapoton states, in times of high returns a yield from the control stock may be "relatively low" even though sufficient to finance a 5 percent payout. Yet this may happen with any other non-control stock that pays lower than prevailing dividends. But if we are especially concerned about control stock (because of the unlikelihood that it will voluntarily be sold), then it is true that there is not much pressure to demand a higher-than-5 percent return, for section 4944s restrictions on "jeopardizing investments" do not apply to contributed stock. A second problem (not, to my knowledge, addressed in the statements submitted to this Subcommittee) is the fact that, even if a foundation holding low-yield control stock can meet the 5 percent payout requirement out of non-control stock, an excessive deduction may have been taken. The prior contribution of the control stock

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\(^5\) Assistant Secretary Chapoton proffers one other remaining problem related to inadequate returns: the difficult valuation of closely-held control stock “substantially undermines the effectiveness” of the minimum payout rule. This difficulty, however, arises – and is handled – in many transactional contexts other
will probably have generated an income or estate tax deduction based on a valua-

than the excess business holdings area, and nowhere else, I think, leads to Congressional avoidance of the valuation problem via an assault on the ownership of tough-to-value property.
tion that assumes a level of productivity greater than that realized from the low-yield stock. In other words, if one measure of a stock's worth is the present value of a stream of future returns, and if that stream is not realized, then the stock may be considered to have been overvalued, and the deduction as well.

(What is the measure of a "return" for purposes of determining such an overvaluation? Ordinarily one might include not only dividends and realized capital gains but also unrealized appreciation on the theory that the foundation is free to sell the stock and capture this gain – the return is available to the foundation. In the case of excess business holdings, however, such a sale is not a likely event in the absence of forced divestiture. Because the appreciation of an excess business holding may never be realized in the foundation's hands and made available to charity, it would be reasonable to judge overvaluation on the basis of the stream of dividends and realized capital gains.)

(b) Under the "unfair competition" heading, where the donor's family owns less than 35 percent of the business in question, the self-dealing provision mentioned above does not prohibit the foundation from lending to, or buying stock in, the controlled business on terms – or with forbearance – not available to competing businesses. Under fiduciary principles reflected in state law regulating charitable trustees and also in the "jeopardizing investment" rule of code section 4944, that investment should be made – and policed – on terms calculated to maximize the foundation's return, but neither state attorneys-general and state courts nor the IRS will be able to spot all preferential sweet spots in such investments.
The Proposed Resolution

And thus the dilemma presents itself. On the one hand, existing federal and state law does not eliminate all the risks that can plausibly be attributed to excess business holdings. On the other hand, section 4943’s response – a major regulatory intervention that seeks, in effect, to eliminate the risks by eliminating the business holdings – brings with it a countervailing set of plausible risks, outlined earlier. I suggest that the dilemma can be resolved along the following lines.

Section 4943 would be amended to permit foundations and their donors to elect an optional regulatory treatment – an alternative to divestiture of excess business holdings that would subject the foundation and donor to special strictures as the price for indefinite retention of the holdings in foundation hands. The optional treatment could be set forth in an addition to section 4943 numbered section 4943B; I will refer to this alternative regulation as "section 4943B" treatment. A section 4943B election could be made within one year of receipt of an excess business holding or one year after passage of the amendment, whichever is later. Various section 4943B strictures can be imagined; here are the ones that address the 1969 Congressional concerns in the light of regulatory deficiencies discussed above:

1. Inadequate return. In order to deal with the possibility of a low return from an excess business holding, two strictures might be imposed on foundations electing section 4943B non-divestiture treatment.

   First, section 4944 would apply to the excess business holding, despite the usual exemption of contributed property, so that the control stock could be deemed to be a
"jeopardizing investment" if it did not meet section 4944's standards for productivity.

These standards would not necessarily condemn low-dividend stock, especially when "taking into account the foundation's portfolio as a whole" (reg. section 53.4944-1(a)(2)), but section 4944 would require close scrutiny of the contribution of the stock to the financial health of the foundation.6

Second, in the event of a low return from dividends and realized capital gains, the donor's income or estate tax deduction could be subject to "recapture" in later years. I have not had an opportunity to work out all the details of – or identify all of the problems associated with – such a recapture arrangement, but here is a rough preliminary sketch of how it might work.

A foundation electing section 4943B treatment would file a special addendum to its Form 990-PF every three (or perhaps four or five) years, specifically reporting the dividends and capital gains realized from that stock during the preceding three (or four or five) year period. This report would include a computation of how this income compared to a "target" annual income figure fixed by statute or regulation, based on a fixed percentage of the book value of the stock in the foundation's hands,7 or based on a percentage of current market values that represent the prevailing rate of realized return from institu

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6 The regulations, which now call for a one-and-only examination of an investment asset when it is first purchased, could be amended to call for this examination when an excess business holding is first donated to the foundation, or if donated prior to the amendment of the regulations, upon the effective date of the amendment. The regulations would have to be further amended to make it clear that the excess business holding is not to be faulted on the ground that it results in an undiversified portfolio; this is one outcome of the contributed-property exception to section 4944 that needs to be retained so as not to negate the effect of the section 4943B option.

7 This figure might be 5 percent. Since, as noted earlier, the measure of return we are using is not "total return" (including unrealized appreciation), the percentage would presumably be lower than that which would be an expected "total return" percentage.
tional portfolios. Where the income received by the foundation was less than, say, 85 percent of the "target" income figure, the shortfall would be reported to the donor, who would, on his or her next tax return, add the amount of the shortfall to gross income as an approximate recapture of the original "excess" deduction. 8

This approach deals with the recapture of a prior income tax deduction where the donor is alive at the time of the shortfall. If the donor is no longer living at the time of the shortfall, or if the original deduction was an estate tax allowance for a testamentary gift of the excess business holding, a recapture from the donor or his estate would be impossible or inordinately awkward, especially if the estate is no longer open. An arrangement resembling transfer of tax liability by contract or by agreement with the IRS 9 would meet this problem. In order for the foundation to elect the section 4943B treatment, there would have to be in effect an agreement between the donor and some other person or institution (presumably a family member or family trust); this substitute obligor would be contractually committed to report the shortfall as income on his or her or its own income tax return. (To avoid selection of a low-bracket substitute obligor, a floor might be set on the tax rate applied to the recapture.) This requirement would not (and could not) apply to any donor who died prior to the enactment of section 4943B. Moreover, it might be

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8 The theoretically preferable solution under “tax benefit” principles is to calculate that portion of the original deduction (in year X) that represents the capitalized value of the later shortfall and to add the resulting amount to gross income on the current tax return. My proposal would achieve very roughly the same effect, except that, in effect, it adds to gross income an amount reflecting interest on the “excess” deduction dating from year X to the current year.

9 See 4 Bittker, Federal Taxation of Income, Estates and Gifts, section 111.5.7 (1981).
well to limit the length of time the substitute obligor would live in Damocletian suspense; the obligation would terminate, let us say, ten years after the donor's death.\textsuperscript{10}

This recapture scheme is complicated (although no rival of the present section 4943!). Moreover, in view of the possible salutory effect that sections 4942 and 4944 and state policing may have on the productivity of corporate control stock, it is not clear that the scheme I have proposed would recapture many taxable dollars. Were we not faced with a dilemma concerning excess business holdings, I would probably not recommend adoption of the recapture provision. But such a provision merits consideration at this time as a measure that can help to resolve this dilemma, by giving some extra reassurance to those who are concerned about the income productivity of excess business holdings.

2. "Unfair Competition." In order to deal with the concerns about the competitive injury that might result from foundation financing of a controlled business\textsuperscript{11} – investments made and/or policed on a preferential basis but not amounting to a breach of section 4941 or 4944 or state law – there is a fairly simple answer. Those foundations electing section 4943B treatment would be subjected to a special self-dealing provision added to code section 4941 that would preclude all debt or equity financing of a company the stock of which constitutes an excess business holding for a foundation. Two possible exceptions to this prohibition that might deserve consideration are these: (a) financing provided through

\textsuperscript{10} This recapture plan is an inexact mirror image of a proposal by the Treasury Department in its 1965 Report on Private Foundations that “unproductive” property donated to a foundation not give rise to a deduction “until the asset is (a) made productive, (b) disposed of, or (c) applied to charitable uses” (p.59).

\textsuperscript{11} I wish to reiterate that I know of no recent data base that provides empirical support for this concern or for the “inadequate return” concern discussed above.
the purchase of securities on a national exchange; (b) financing that has the specific approval of the IRS or a state court having supervisory jurisdiction.

3. "Distraction." Although, as noted earlier, the "distraction" claim lacks not only empirical support but also plausible rationale, an alternative (section 4943B) treatment of excess business holdings could address this issue along with the others. There are, of course, limits on what legislation can do to prevent "distraction." Regulation cannot operate directly on a state of mind; moreover, it is doubtful that anyone would seek to prevent a foundation's trustees and officers, as fiduciaries, from paying attention to the health of any of the foundation's investment holdings, whether "excess business" or otherwise. But regulation can offer those worried about "distraction" some reassurance that foundation personnel (trustees or staff) who have charitable program responsibilities are not drawn into the day-to-day management of the controlled business enterprise. A quest for such reassurance is presumably one reason for recent discussion of the possibility of reducing the "interlock" between the foundation and a controlled business. It is difficult to distinguish, legislatively, "interlock" that may have a tendency to "distract" the foundation's program personnel from "interlock" that involves the foundation's financial personnel, for trustees and top staff are often concerned with both sides of the foundation. Accordingly, an "interlock" provision probably will have to disregard the program-finance distinction.

It could be provided, then, that foundations electing the alternative (section 4943B) treatment will have to reduce to one or two the total number of their trustees and staff personnel who also serve as directors, officers, or employees of the controlled company. I have not proposed a 100 percent elimination of "interlock" because that might be inconsistent with the rationale for the section 4943B alternative treatment. One reason for the
The 4943B option is to respond to the concern about the possible disincentive effect of present section 4943 on the gifts of capital stock to foundations. Telling a donor that he or she must either give up a role in what is often the family business or quit the family foundation may have an almost equally chilling effect on the donor's willingness to make the control stock contribution. Leaving room for a limited "interlock" should avoid such discouragement.

The reader is reminded that none of the foregoing section 4943B provisions would come into play unless the foundation elected the alternative treatment. Some foundations will prefer to stick with the divestiture option, either because divestiture is relatively easy for them and their donors to adjust to, or because they prefer divestiture to the regulatory regime imposed by section 4943B.

Some Loose Ends

Past divestitures. The enactment of a section 4943B option along the lines set forth above would leave, in its wake, a number of foundations that had already completed section 4943 divestiture and could not hope to return to the status quo ante. While, from their perspective, it would be unfortunate that the 4943B option had not been available when they went through the throes of divestiture, that can not be a reason for rejecting corrective legislation at this time. An amendment otherwise desirable on its merits ought not be cast aside because it comes too late to be of benefit to all affected parties. The conclusion might be otherwise if the affected parties were commercial competitors, with substantial unfairness the result of a change in ground rules, but that is not the case here.
In the absence of a competitive unfairness problem, I see no reason not to make the 4943B option available at once to all foundations – not only those that will receive excess business holdings in the future but those that already have such holdings on the date of section 4943B's hypothesized enactment.

**Applicability to public charities.** In suggesting the 4943B amendment. I have not taken up the issue of whether the excess business holdings rules – with or without the suggested amendment – should be faulted for dealing only with foundations and not with other charitable bodies that hold corporate control stock. (The tendency of non-foundation charities to hold such stock may have increased since 1969, when the Congress in effect declared foundations to be the only ineligible receivers). The issue of discrimination against foundations has been raised in connection with H.R. 3043, proposed legislation recently introduced by Reps. Conoble, Shannon, Frenzel and Gephardt to eliminate certain "tax disincentives for gifts to foundations." The section-by-section analysis of this bill states that these disincentives "have contributed to a dramatic reduction in giving to foundations" and characterizes them as "discriminatory tax rules." The excess business holdings provision – applicable only to foundations – can also be characterized as a "discriminating tax rule." The section 4943B election outlined here would not end such discriminatory treatment, but, by providing an option to forced divestiture, it would moderate the impact of the discrimination.

**Extended divestiture deadlines.** Adoption of the alternative treatment plan proposed here should not preclude enactment of amendments to section 4943 permitting extension of the five-year deadline for divestiture of holdings received after May 26, 1969 (as provided in S. 562). A strong case has been made, in my opinion for permitting such
extension, and that case deserves to be considered on its own merits regardless of the disposition of the alternative treatment I have outlined.

**Conclusion**

It is probably rare, in the annals of legislation, to come upon a controversy that can be resolved in a way that honors the views and concerns of both sides. The excess business holdings controversy appears to be one of those rarities. Because of the national interest in the health of private philanthropy, I hope that the Committee on Ways and Means will take advantage of such an unusual opportunity. The proposal I have outlined here is intended to invite the Committee's attention to this opportunity – and suggest one way to seize it.

Respectfully submitted,

John G. Simon

**NOTE:** This statement is made in a personal capacity on the basis of my research and teaching, over a period of many years, on the role and regulation of philanthropy. Although my work has been based both at the Yale Law School and the Yale Program on Non-Profit Organizations, my statement does not represent the position of either of these institutions. The Program on Non-Profit Organizations, as noted in my statement, is conducting a major empirical study, in conjunction with the Council on Foundations, that bears on some of the issues discussed herein, but that study is now in its infancy, and
therefore its results are not and could not possibly be reflected in my statement. I also note, in the interests of full disclosure, that I am a trustee and President of a relatively small private foundation – one that has never had any excess business holdings and has no prospect of ever receiving any.