

Edited: 4/27/05

Reconsidering Private Foundation Investment Limitations

Richard Schmalbeck*

* Professor, Duke University School of Law. Copyright © Tax Law Review, NYU School of Law. The article originally appeared at 58 Tax L. Rev. 59 (2004). I am indebted to Joel Fleishman, David Jones, Marcus Owens, Celia Roady, Stephen Schwarz, Thomas Troyer, and participants in the NYU Conference on Managing Charitable Assets for helpful comments on the general subjects of this Article, and to Pamela Reyburn for her research assistance. They are, of course, not responsible for any errors this Article may contain, nor do they necessarily endorse any of the positions adopted herein.

I. Introduction

This Article suggests reconsideration of the two mainstays of investment regulation of private foundations—the excess business holdings rules of § 4943, and the jeopardizing investment rules of § 4944. I argue that reconsideration reasonably would lead to reforming the former and repealing the latter. These suggestions run against a prevailing mood that could be described as a deregulation counter-revolution, characterized by regret that efforts to unleash securities markets, public utilities, and the telecommunications industry, among others, may have overshot their marks.¹

The arguments in this Article, however, are not based on an assumption that private foundations are now so well-behaved that self-regulation can replace the heightened scrutiny to which they have been subject since 1969. Rather, it is simply that the particular tools incorporated into the Code in § 4943 and § 4944 in part were ill-conceived from the outset, and, in any event, are ill-suited to their tasks today. They impose regulatory costs without producing significant regulatory benefits.

The Article proceeds as follows: Section II provides historical context. Section III outlines the current penalty provisions; Section IV provides the rationale given for these rules; and Section V critiques this rationale. Section VI discusses the costs associated with the penalty provisions and Section VII explains my conclusions.

II. Background

During roughly the middle third of the last century, foundations were beleaguered by intense, and in large part justified, criticism, covering a broad range of grounds.² Most of the criticism had as a common root a fundamental aspect of private foundations: that donors or their designates continued to control foundation assets for many years following

¹ See, e.g., Joseph E. Stiglitz, *The Roaring Nineties* (2003), especially ch. 4 (*Deregulation Run Amok*), at 87-114.

² As one observer of the charitable world put it in 1965, “[i]n the past 15 years . . . foundations have lived in something approaching a condition of siege.” John G. Simon, *The Patman Report and the Treasury Proposals*, NYU Seventh Biennial Conference on Charitable Foundations 141, 142 (1965). While the reference appears to encompass the years from 1950 to 1965, it seems likely that the siege started somewhat before that; the legislative history of the Revenue Act of 1950 offers a catalog of abuses that had existed for some time prior to that act. S. Rep. No. 2375, 81st Cong. 88 (1950), reprinted in 1950-2 C.B. 483, 502-12.

their initial creation and endowment. That fact, coupled with the historically low levels of oversight of their operations and the virtual absence of legal constraints, created multiple opportunities for abuse.

For example, prior to the enactment of minor reforms in 1950³ and more significant ones in 1969, private foundations were free to make asset purchases from and sales to a donor, the donor's family members, and the donor's controlled corporations; they could accumulate income in the discretion of their trustees, thereby deferring indefinitely the distribution of any value to charitable ends; and they could operate businesses, sometimes on terms that were thought to provide an unfair advantage over competing firms that were organized as profit-seeking entities.

The virtually unregulated foundation world at mid-century was thus, by all appearances, a metaphoric wild west, (but with a Park Avenue address). Of course, many foundations were able to resist the temptations offered by that environment, and performed their charitable functions well and faithfully. But some were not, and did not.

In 1950, Congress enacted a series of measures aimed at curbing abuses, primarily as to competition with profit-seeking firms, self-dealing, unreasonable accumulation of income, and public reporting.⁴ This response, however, was broader than it was deep, and the reforms proved to be largely ineffective. Criticism of private foundations continued to mount through the 1950's.⁵ It reached a peak early in the following decade, particularly in hearings conducted by Congressman Wright Patman and the Subcommittee on

³ See note 4.

⁴ Revenue Act of 1950, Pub. L. No. 81-814, ' 301, 64 Stat. 906, 947 (unrelated business income); ' 321, 64 Stat. 954 (prohibited transactions and accumulated income); ' 341, 64 Stat. 960 (public disclosure requirements). Portions of the descriptions of the legislative history and substantive provisions of ' 4943 are based on an unpublished paper by the author written in 1999 on behalf of a private client. That paper argued that the de minimis amount specified in ' 4943(c)(2)(C) (described in Section III.A.) should be raised from 2% to either 5% or 10%.

⁵ There were a number of congressional hearings relating to alleged private foundation abuses in the early fifties, held by committees chaired by Congressman Cox (1951 and 1952) and by Congressman Reece (1954), which are described in considerable detail in René A. Wormser, *Foundations: Their Power and Influence*, app. B., at 328-83 (1958). Although these hearings involved complaints about what might be called tax abuses, they appear to have been directed mostly at the perceived political content of private foundations' programmatic agendas at that time, which allegedly included financing of radicalism, Communism, and the Kinsey Report, among other evils.

Foundations of the House Select Committee on Small Business. Those hearings culminated in 1964 in a three-volume, 872-page report that was scathing, if not always balanced, in its catalogue of private foundation abuses.⁶

In the midst of the Patman hearings, and in response to requests from the Finance Committee and the Ways and Means Committee, Treasury undertook its own study of private foundations.⁷ The resulting report, which was sent to Congress in February, 1965,⁸ was more nuanced than the several reports Congress itself had produced, and won praise from one distinguished academic observer as an "urbane and sophisticated document . . . thoughtful and craftsmanlike."⁹ It included a detailed set of proposals that were intended to preserve the valuable contributions that private foundations made to the charitable sector, (which the report readily acknowledged) while curbing the abuses that by that time had been documented repeatedly.

In particular, the report closely examined six problem areas: self-dealing, delay in benefit to charity, foundation involvement in business, family use of foundations to control corporate and other property, financial transactions unrelated to charitable functions, and broadening of foundation management. The remedies proposed were quite comprehensive, almost to the point of conscious redundancy. The authors of the report must have been acutely aware of the shortcomings of the measures adopted in 1950, and no doubt wanted to be sure that their proposed solutions would be fully adequate to deal with the regulatory challenges posed by private foundations. And, because they had no

⁶ Chairman's Report to the House Select Comm. on Small Business, 87th Cong., Tax-Exempt Foundations and Charitable Trusts: Their Impact on Our Economy (Comm. Print 1962); 88th Cong. (Comm. Print 1963) (second installment); 88th Cong. (Comm. Print 1964) (third installment) [hereinafter Patman Report].

⁷ The 18-month study involved consultation with the IRS National Office and field audit staffs, and with a special advisory committee on private foundations appointed by Secretary of the Treasury Douglas Dillon. It included a special survey of some 1300 private foundations. See Lawrence M. Stone, The Background of the Treasury Department Report on Private Foundations, NYU Seventh Biennial Conference on Charitable Foundations 181 (1965) (Stone served as Treasury's Tax Legislative Counsel during the preparation of the study.) Further elaboration on Treasury's work on this project can be found in Thomas A. Troyer, The Treasury Department Report on Private Foundations: A Response to Some Criticisms, 13 UCLA L. Rev. 965 (1966).

⁸ Senate Comm. on Finance, 89th Cong., Treasury Department Report on Private Foundations (Comm. Print 1965) [hereinafter Treasury Report].

⁹ See Simon, note 2, at 143-44.

way of knowing which parts, if any, of their proposals actually would be enacted, each set of remedies to some degree needed to be independent of the others, so as to be a reasonably self-sufficient solution to the perceived problems in each area, even if the other proposals were not enacted.

A few years and still more hearings later,¹⁰ Congress adopted most of the proposals put forth in the Treasury Report.¹¹ That act contained amendments to the Code defining private foundations in great technical detail, prohibiting most types of self-dealing and a variety of other potentially troublesome transactions, requiring mandatory annual distributions for charitable purposes of at least 6% of each foundation's assets,¹² and regulating grant-making procedures. Further, and most significantly for present purposes, Congress imposed two excise taxes intended to regulate private foundations' investments: The first effectively limited the percentage of voting stock of a corporation that could be held by a private foundation;¹³ the second penalized foundations for investments that would jeopardize the organization's charitable purposes,¹⁴ by which Congress appears simply to have meant investments involving excessive risk.

In the view of many in the field, including the author of this Article, the 1969 private foundation rules, taken as a whole, should be counted among the more successful tax reform efforts of the latter half of the 20th century. Private foundations still have their critics, but the tenor of the criticism has changed markedly since the passage of the 1969 Act. Prior to that time, most of the focus was on case studies of foundations that had paid inflated prices for assets purchased from foundation insiders, or foundations that had all of their assets invested in corporations that paid few or no dividends, so that no more than modest distributions were made to grant recipients. The Act seems to have been effective in removing most of those abusive practices from the private foundation landscape. More

¹⁰ See particularly Hearings on Tax Reform Act of 1969 Before the House Ways and Means Comm., 91st Cong. (1969).

¹¹ Tax Reform Act of 1969, Pub. L. No. 91-172, ' 101(a), 83 Stat. 487, 492 [hereinafter 1969 Act] (adding ' ' 507-509), ' 101(b), 83 Stat. 498 (adding ' ' 4940-4948).

¹² The Tax Reform Act of 1976, Pub. L. No. 94-455, ' 1303(a), 90 Stat. 1520, 1715, reduced the 6% minimum distribution requirement to the current 5% level.

¹³ IRC ' 4943.

¹⁴ IRC ' 4944.

recent criticism focuses on whether the payout rate of 5% is sufficiently large, whether foundations use up too much of the 5% in administrative costs, and whether private foundation boards are entwined excessively into the fabric of privilege among America's wealthy.¹⁵ Whether one agrees with these criticisms or not, it is clear that they are qualitatively different from the pre-1969 complaints: With only occasional exceptions, it is no longer true that the private foundation subsector can be accurately characterized as a sinecure of private wealth, created and held primarily for private benefit.¹⁶

Perhaps the most compelling evidence of the success of the 1969 Act reforms is simply that they have endured. Modest changes have been made in the 34 years since passage, but the overall 1969 framework of the tax law governing private foundations remains remarkably intact to this day. Further, while the trend in virtually every other area of the tax law has been to tighten the applicable rules in an effort to reduce abuses,¹⁷ the pattern in the private foundation area has been to relax, albeit only slightly, the tight grip of the 1969 reforms.¹⁸ While some critics worried about the possibility that the complexity of the 1969 rules would proliferate, making the area in time nearly impossible for tax practitioners and foundations to deal with,¹⁹ the actual experience has shown that these fears have not been realized.

Indeed, the 1969 reforms may well have proven to be more restrictive than necessary in some ways. The authors of the leading casebook on exempt organizations,

¹⁵ The first two criticisms are detailed by Gilbert M. Gaul & Neill A. Borowski, *Free Ride: The Tax-Exempt Economy 160-76* (1993). The third is, broadly, the subject of Teresa Odendahl, *Charity Begins at Home: Generosity and Self-Interest Among the Philanthropic Elite* (1990).

¹⁶ There are exceptions, of course. See Dori Meinert, *Bielfeldt: A Fortune Lost?*, available at http://copleydc.com/copleydc_staff/Meinert/bielfeldt_series.htm.

¹⁷ The list is almost endless, but to mention a few: IRC ' 465 (at-risk rules), ' 1272 (time value of money rules), ' 469 (passive loss limitations), ' 311(a) (repeal of the General Utilities doctrine), ' 280A (limitations on deductions for home offices), ' 165(h) (casualty losses), ' 213 (medical expenses), ' 67 (miscellaneous itemized deductions).

¹⁸ A few of these include: IRC ' 170(e)(5) (the opportunity to deduct the fair market value of publicly-traded stock given to private foundations), ' 170(d) (the opportunity to carry over excess contributions for five years), ' 170(b)(1)(B) (the increase in the deductible percentage of income from 20% to 30% for most gifts to private foundations), and ' 4940(a) (the reduction of the private foundation excise tax on investment income from 4% to 2%).

¹⁹ An article by Crane C. Hauser that appeared shortly after the Treasury Report was issued carried a title that said it all: *Tax Problems of Foundations: Another Subpart F in the Making?*, 43 *Taxes* 793 (1965).

perhaps reflecting this view, have described the 1969 rules as "punishment inflicted" on foundations.²⁰ Whether the 1969 rules were intended to be punitive or not, this Article argues for reconsideration of at least the two major excise taxes—the rules relating to excess business holdings, and jeopardizing investments. After describing and analyzing each set of rules, I offer some tentative conclusions, to the effect that the excess business holdings rules should be significantly amended, and the jeopardizing investments rules repealed altogether.

III. The Rules

As noted, the 1969 Act imposed separate rules relating to excess business holdings, and jeopardizing investments. The following two Subsections provide brief explanations of the two respective sets of rules in their current form.

A. Excess Business Holdings

Section 4943 imposes an excise tax on foundations that hold, at any time during their tax year, more than 20% of the voting stock of any corporation.²¹ For purposes of this measurement, voting stock held by a private foundation is aggregated with all voting stock held by those who are "disqualified persons" with respect to that foundation²²--a group that includes founders, substantial contributors and their family members, and foundation managers.²³ The 20% maximum applies principally to the voting stock of the corporation; as long as disqualified persons own no more than 20% of the voting stock, the foundation is not limited in its holdings of nonvoting stock.²⁴ Under limited, and

²⁰ James J. Fishman & Steven Schwarz, *Nonprofit Organizations--Cases and Materials* 602 (2d ed. 2000).

²¹ IRC ' 4943(a)(1) (5% tax), ' 4943(c)(2) (20% limit). If the excess was not the result of a foundation purchase, the foundation has 90 days in which to dispose of the excess holdings without imposition of the first-tier penalty. Reg. ' 53.4943-2(a)(1)(ii).

²² IRC ' 4943(c)(2)(A)(ii).

²³ IRC ' 4946(a).

²⁴ IRC ' 4943(c)(2)(A); Reg. ' 53.4943-3(b)(2). The strong negative inference of the Code and regulations language is that if the disqualified persons and the foundation *do* own more than 20% of the voting stock, then the foundation can hold no nonvoting stock; however, neither the Code nor the regulations explicitly state this.

presumably unusual, circumstances--where it can be shown that shareholders other than disqualified persons hold controlling interests in the corporation--a limit of 35% of the stock is allowed instead of 20%.²⁵ Similar rules apply to interests in noncorporate businesses.²⁶

The excise tax has two tiers. An initial tax of 5% of the value of the excess business holdings--that is, stock in excess of the 20 or 35% maximum--is assessed in any year in which there is an excess.²⁷ Generally, if the excess stock is not divested prior to the issuance of a notice of deficiency with respect to the first-tier tax, a second-tier tax of 200% of the excess holdings will be assessed.²⁸ There is, however, a five-year grace period--and the possibility of an additional five-year extension in some cases--allowed for the disposition of stock received by inter vivos or testamentary gift, during which neither the 5% nor the 200% taxes apply.²⁹

A 2% de minimis rule applies to the direct stockholdings of a private foundation (that is, the stock that actually is owned by the foundation, rather than constructively owned through attribution from a disqualified person).³⁰ The effect of the rule is to allow a foundation to hold directly as much as 2% of the stock of a corporation, even if more than 18% of the stock of the corporation is owned by disqualified persons. Without this rule, ownership by the foundation of even a single share of stock of a corporation controlled by disqualified persons would trigger the excess business holdings excise tax.³¹

Code provisions also provide rather generous grandfathering of stockholdings that

²⁵ IRC ' 4943(c)(2)(B).

²⁶ IRC ' 4943(c)(3).

²⁷ IRC ' 4943(a)(1). In addition to the 90-day disposition period mentioned in note 21, ' 4962(a) allows abatement of the first-tier tax if the foundation can show that the existence of the excess was "due to reasonable cause and not to willful neglect," and was promptly corrected.

²⁸ IRC ' 4943(b). Like the first-tier tax, this too is subject to abatement under ' 4961 if the excess holding situation is corrected.

²⁹ IRC ' 4943(c)(6) (the standard five-year period), ' 4943(c)(7) (the five-year extension possibility).

³⁰ IRC ' 4943(c)(2)(C).

³¹ Section 4943(c)(2)(C) requires that the holdings of all related foundations be used in applying the 20% limit, and the 2% de minimis rules. This aggregation of related foundations is based on the definition in ' 4946(a)(1)(H), which imposes a test based on either effective control or substantial identity of contributors.

existed at the time the excess business holdings rules were added.³² The grandfathering was intended to provide lengthy opportunities for gradual divestiture of excess business holdings, depending in part on how extensive those holdings were in 1969. The details of these rules are of limited relevance to this Article; it will suffice to note that, in the most extreme cases, where a foundation and its disqualified persons owned more than 95% of the voting stock of a corporation, the foundation had a 20-year period within which to reduce its holdings to 50%, and another 15-year period within which to reduce its holdings to 25%.³³ The grandfathering rules also contain a so-called "downward ratchet" that provides that if the holdings of the foundation (together with those of the disqualified persons) decrease, then the grandfathered percentage holding permitted will decrease concomitantly.³⁴ Thus, if a foundation for any reason disposes of stock, it generally is not allowed to reacquire stock to restore its former percentage holding, if that holding would exceed that which otherwise would have been permitted under the general excess business holding rules.

B. Jeopardizing Investments

Section 4944 imposes an excise tax on both the foundation and its managers if it invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes³⁵ The Code provisions lack specificity about what kinds of investments those might be, but the legislative history and background behind this provision suggest that what Congress primarily meant was simply investments that were unduly risky.³⁶ The regulations suggest that jeopardizing investments are those where the managers have failed to exercise ordinary business care and prudence . . . in providing for

³² IRC ' 4943(c)(4). In general, holdings acquired on or before May 26, 1969 are protected by the grandfathering rules.

³³ IRC ' 4943(c)(4)(A), (D). Under some circumstances (where the disqualified persons own less than 2% of the stock), the final percentage holdings of the foundation and its disqualified persons may be as high as 35%. IRC ' 4943(c)(4)(D).

³⁴ IRC ' 4943(c)(4)(A)(ii).

³⁵ IRC ' 4944(a)(1). Section 4944(a)(1) imposes the tax on the foundation; ' 4944(a)(2) imposes the tax on any knowing managers in a case where liability is found under ' 4944(a)(1).

³⁶ See Sections IV.A. and B, discussing the rationale offered by Congress and Treasury.

the long- and short-term financial needs of the foundation³⁷ The regulations yield a bit more detail, along with a list of suspects: Trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls, and straddles, the purchase of warrants, and selling short.³⁸ But the regulations explicitly say that no category of investment is per se jeopardizing.³⁹

There are two important exceptions to the general prohibition of risky investments. The first is for so-called program-related investments.⁴⁰ This is intended to allow foundations to make investments, typically loans, that are intended primarily to accomplish the organization's charitable ends, rather than to generate financial returns for the organization. Thus, a foundation whose purpose is to foster community development would be allowed to make below-market-rate loans to community development organizations, which in turn would lend the funds to businesses that were willing to invest the proceeds of the loans in creating or expanding commercial or industrial enterprises within an affected development zone.⁴¹

A second exception allowed by the regulations but not specifically in the Code applies to property received by gift.⁴² While no explicit explanation is offered for this provision, it presumably reflects the notion that investments received as gifts need not, and do not, reflect portfolio selections of the foundation or its managers, so they should not be charged with any sort of responsibility for them. This seems sensible enough as applied to assets that may have little or no liquidation value. One wonders, however, why the regulations do not insist that gratuitously received *marketable* investments that may be jeopardizing be replaced by ones that are not, within some reasonable time. But the rules do not go that far.

If an investment is found not to reflect ordinary care, and does not reasonably advance an exempt purpose of the organization, an initial excise tax equal to 5% of the

³⁷ Reg. ' 53.4944-1(a)(2)(i).

³⁸ Id.

³⁹ Id.

⁴⁰ IRC ' 4944(c).

⁴¹ Rev. Rul. 85-162, 1985-2 C.B. 275.

⁴² Reg. ' 53.4944-1(a)(2)(ii).

amount invested may be assessed against the organization,⁴³ and a separate 5% tax may be assessed against the manager making the investment.⁴⁴ If the foundation does not dispose of the investment before the date of a notice of deficiency or the assessment of the first tax, then a second-tier tax of 25% of the amount of the jeopardizing investment may be assessed against the foundation,⁴⁵ and another 5% tax may be assessed against any manager who refuses to dispose of the jeopardizing investment.⁴⁶ The tax may be abated, however, if the jeopardizing situation is resolved within 90 days of the assessment.⁴⁷ And the rules applying to foundation managers include dollar limitations on their liabilities for any single jeopardizing investment of \$5,000 for the first-tier tax, and \$10,000 for the second-tier.⁴⁸

In light of the amorphous texture of their central concept what constitutes a jeopardizing investment one might expect that these rules would have produced a significant number of disputes, at least some of which would have been litigated.⁴⁹ But that would be wrong. A search of the literature reveals a substantial number of private letter rulings and a few revenue rulings. But while there are a few cases involving the periphery of ' 4944, there do not appear to be any cases interpreting the Ajeopardizing investments@ concept that is at its core.⁵⁰

⁴³ IRC ' 4944(a)(1).

⁴⁴ IRC ' 4944(a)(2).

⁴⁵ IRC ' 4944(b)(1).

⁴⁶ IRC ' 4944(b)(2).

⁴⁷ IRC ' ' 4962(a), 4963(e)(1).

⁴⁸ IRC ' 4944(d)(2).

⁴⁹ In contrast, the relatively definitive rules of ' 4943 do not appear to leave much that is open to varying interpretation, so it is less surprising that there is little case law interpreting that section.

⁵⁰ One case dealt with whether a claim against a foundation manager constituted a tax claim or not. See *In re Kline*, 403 F. Supp. 974 (D. Md. 1975). Another dealt with whether a second-tier tax could be imposed on a manager where the Service had not made an appropriate request to dispose of the jeopardizing investment. *Thorne v. Commissioner*, 99 T.C. 67 (1992). But aside from those procedural details, there appears to have been no litigation at all regarding ' 4944. Thus, the words of the Code section itself, elaborated by the relatively brief set of regulations, are virtually the only sources of law in this area. The obvious inference from the lack of evidence of IRS action in this area is that the Service has not have been particularly aggressive in enforcing these provisions. This possibility is discussed in Section VI, on the costs of regulation.

IV. The Rationale for the Rules

A. Congressional Rationale

The rules described above, enacted as part of the Tax Reform Act of 1969,⁵¹ have survived the intervening 35 years virtually intact.⁵² The principal legislative history materials are contained in the committee reports accompanying that Act. The congressional explanations are a bit scanty, at least by more contemporary standards. I describe them immediately below only partly to convey their substantive content. A more important purpose is to provide verification of an assertion I make in the following Section: That the 1965 Treasury Report provides a fuller and more accurate statement of the purposes and intent of these provisions. What the reader will note, I hope, is that the official committee reports are little more than executive summaries of the more detailed consideration of the germane topics provided four years earlier by Treasury.

1. Excess Business Holdings

The House bill and the Senate amendment contained substantially similar provisions with respect to excess business holdings, with only modest disagreements over the details of the grandfathering provisions for pre-1969 excess business holdings. In the House report, the "general reasons for change" section relating to the excess business holdings materials is so brief that it may be quoted here in its entirety:

The use of foundations to maintain control of businesses, particularly small family corporations, appears to be increasing. It is unclear under present law at what point such noncharitable purposes become sufficiently great to disqualify the foundation from exempt status. Moreover (as indicated above under self-dealing) the

⁵¹ Tax Reform Act of 1969, Pub. L. No. 91-172, ' 101, 83 Stat. 487, 511-12.

⁵² Of the rules described, only the possibility of an extra five-year divestiture period, and some of the details of the grandfathering of pre-1969 excess business holdings, post-date the 1969 Act. Those provisions were added to the Code by the Tax Reform Act of 1984. See, e.g., Tax Reform Act of 1984, Pub. L. No. 98-369, ' 307, 98 Stat. 494, 784-85 (enacting the five-year divestiture extension); see also note 29 and accompanying text.

sanction [presumably, the loss of exempt status] under present law is apt to be too harsh.

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. 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. Where the charitable purposes predominate, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses. 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.⁵³

The slightly lengthier Senate counterpart⁵⁴ begins with the same initial paragraph, then cites three examples taken from the 1965 Treasury Report, all of which involve situations in which private foundations operated large numbers of businesses, in some cases directly, and in some cases by leasing the business assets to active managers, in exchange for a share of the business profits.⁵⁵ The report then notes a newspaper advertisement, placed by a private foundation seeking businesses to purchase, as evidence that the phenomenon was continuing rather than merely historical.⁵⁶ Finally, this portion of the Senate report concluded with language virtually identical to that in the second paragraph of the House report.⁵⁷

Both reports continue with an explanation of the very similar provisions of the House bill and Senate amendment, in very similar terms. Interestingly, both reports mention the de minimis rule only in a footnote, and without any explanation of any separate rationale that the de minimis rule may have had.⁵⁸

⁵³ H.R. Rep. No. 91-413, at 218, reprinted in 1969-3 C.B. 200, 218.

⁵⁴ See S. Rep. No. 91-552, reprinted in 1969-3 C.B. 423.

⁵⁵ See id. at 449-50.

⁵⁶ See id.

⁵⁷ See id.

⁵⁸ See H.R. Rep. No. 91-413, note 53, at 218 n.5, reprinted in 1969-3 C.B. at 218 n.5; S. Rep. No. 91-552,

2. Jeopardizing Investments

The House report on the reasons for the jeopardizing investments rules consists of but a single paragraph, which notes that the charitable exemption and contributions deduction rules are premised on a benefit accruing to charity, which will not reliably happen unless the assets of the organization are carefully managed.⁵⁹ The report went on to note that rules rather like the jeopardizing investments rules already applied to the *income* earned by foundations, so extending similar rules to the corpus of the foundation assets seemed an obvious and logical extension of existing law.⁶⁰ Finally, the report lamented the lack of sanctions less severe than loss of exemption, by way of explaining the excise tax approachCwhich provides something of an intermediate sanctionCto this problem.⁶¹

The Senate report repeated the concerns of the House, in similar language.⁶² The Senate report added, however, a list of investments that it thought problematic, specifically: Awarrants, commodity futures, and options, or [purchases] on margin.@⁶³ It was in the Senate Finance Committee that the exception for program-related investments was made, and those provisions also are explained in its report, although no separate rationale is offered.⁶⁴ Finally, the Senate report emphasized that the evaluation of the investments for purposes of applying the ' 4944 rules should be made on the basis of information available at the time that the investments were made, rather than with the benefit of hindsight.⁶⁵

note 54, at 450 n.9, reprinted in 1969-3 C.B. at 450 n.9.

⁵⁹ See H.R. Rep. No. 91-413, note 53, at 220, reprinted in 1969-3 C.B. at 220.

⁶⁰ See *id.*

⁶¹ See *id.* at 220-21, reprinted in 1969-3 C.B. at 220-21.

⁶² See S. Rep. No. 91-552, note 54, at 453-54, reprinted in 1969-3 C.B. at 453-54.

⁶³ *Id.* at 453, reprinted in 1969-3 C.B. at 453.

⁶⁴ See *id.*

⁶⁵ See *id.* at 453-54, reprinted in 1969-3 C.B. at 453-54. Language to this effect was not added to the code provision, but does appear in the regulations. See Reg. ' 53.4944-1(a)(2)(i).

B. Treasury Rationale for the Rules

Perhaps the committee explanations are so spare because so much had been said about these problems already. In particular, Congress seems to have treated the Treasury Report as something of an informal legislative history in itself, sometimes referring to the Treasury Report explicitly,⁶⁶ and almost always tracking closely the arguments made in that report.⁶⁷ In light of the clear approbation of that report reflected in the adoption of so many of its proposals, and in the explanations offered for doing so, it seems appropriate for subsequent analysts as well to use the Treasury Report as presenting a more fully elaborated version of the rationales for the 1969 Act private foundation provisions.

Reading the Treasury Report as quasi-legislative history is reasonably straightforward in the case of jeopardizing investments. A section of the report describes A[t]rading and speculation by foundations,⁶⁸ and the obvious import of the section is that those types of investments should be either proscribed or at least subject to close scrutiny.⁶⁸ But reading the Treasury Report as quasi-legislative history as to the excess business holdings rules is complicated slightly by one fact: The Treasury Report actually contained *two* sets of analytical materials and legislative proposals in the business holdings area,⁶⁹ which were oddly merged in the rules Congress ultimately enacted. Under these circumstances, there obviously could be no explicit explanation of the rules derived from the unhappy (it will be argued) marriage of the two sets.

The Treasury Report labeled the first of their business holdings concerns "Foundation Involvement in Business,"⁷⁰ and it was the Treasury proposals in this area that Congress substantially adopted.⁷¹ The second set of materials was called "Family Use of Foundations to Control Corporate and Other Property."⁷² The proposals in this area largely involved rules that would have deferred deductionsCfor both income and estate tax

⁶⁶ See, e.g., S. Rep. No. 91-552, note 54, at 449, reprinted in 1969-3 C.B. at 449. (¶The Treasury Department in its 1965 study of private foundations included the following example@)

⁶⁷ Compare *id.* with Treasury Report, note 8, at 30.

⁶⁸ Treasury Report, note 8, at 52-54.

⁶⁹ See notes 70-75 and accompanying text.

⁷⁰ Treasury Report, note 8, at 30.

⁷¹ See Section III.A.

⁷² *Id.* at 37.

purposes for gifts to private foundations of stock in companies controlled by the donor or his/her family. The deductions would have been deferred until: 1) the donated assets were disposed of by the foundation; 2) in the case of physical assets, until those assets were actually devoted to charitable uses; or, 3) the donor and donor's family ceased to control the business or corporation in question.⁷³ In the case of the income tax deductions, the deferral would have been indefinite; in the case of estate tax deductions, one of the three events noted would terminate the deferral only if that event took place within three years of the date of death. With arguably one exception, explained below, Congress did *not* enact these proposals in 1969.

Under the Treasury proposals, holding voting stock in a corporation that exceeded 20% of the total outstanding shares would have triggered both the foundation involvement and the family use rules.⁷⁴ The family use rules would have aggregated the holdings of the donor and family with the holdings of the foundation for purposes of the 20% test. In contrast, however, the foundation involvement proposals explicitly eschewed the aggregation of foundation holdings with those of any disqualified persons.⁷⁵

The single scrap of the Treasury's family use proposals that Congress ultimately enacted was the use of an attribution rule, which in turn made a *de minimis* rule necessary, or at least highly desirable. Congress saw in the attribution rules a way of incorporating a response to at least some of Treasury's concerns about the use of foundations to help a family maintain control of a corporation. So the rules as actually enacted closely tracked Treasury's foundation-involvement-in-business proposals, but with an attribution rule (and a *de minimis* exception) tacked on to achieve some control of the "family use . . . [to control corporations]" problem.⁷⁶

⁷³ Id. at 42-43.

⁷⁴ Id. at 36, 42.

⁷⁵ In the words of the report: "In determining the quantum of a foundation's stock or business ownership, interests held for the benefit of the foundation (whether by trusts, corporations, or others) should be attributed to it, but interests owned by donors, officers, directors, trustees, or employees for their own benefit should not." Id. at 36.

⁷⁶ That this is so probably could be inferred from a simple comparison of what Treasury proposed to what Congress eventually enacted. I am grateful, however, to Thomas Troyer for confirming in a telephone conversation that the process described in this paragraph was in fact quite explicit, and was performed

What concerns principally animated Treasury's proposals as to regulation of foundation investments? The following paragraphs offer a summary of the concerns in the three areas, distilled from various parts of the Treasury Report:

As to foundation involvement in business, Treasury seemed to be concerned primarily with: (1) competitive disadvantages for other firms in the relevant industry that were organized as profit-seeking entities, (2) opportunities for self-dealing, and, (3) distraction of foundation management from charitable pursuits.

As to family use of foundations to control corporate and other property, Treasury appears to have thought that the possibility of such continued control did not necessarily create additional concerns in itself, but that it made a number of general concerns worse. In particular, self-dealing and delay in benefit to charity were among the problems thought to be exacerbated by family use of foundations to perpetuate corporate control. As to Trading and Speculation by Foundations,⁷⁷ the Treasury concerns were primarily that the foundation never would be able to devote its resources to charitable ends if and to the extent that those resources were lost through imprudent investment. As a bit of an afterthought, though, the report noted that there were also distraction risks involved in some sorts of high-activity trading, of the sort that might characterize commodities markets.

There is clearly some overlap in these concerns that permits reduction of the three lists to the following combined list of concerns in six discrete areas: competitive advantage, self-dealing, delay in benefit to charity, distraction of management, maintenance of control, and imprudent investment. A fuller detailing of these concerns, and an analysis of their weight and merit follows.

mostly at the hands of Laurence Woodworth, the legendary chief of staff of the Joint Committee on Taxation. (Troyer was then Deputy Legislative Counsel in Treasury's Office of Tax Policy, and now practices in Washington DC.)

⁷⁷ Part II.E.3. of the report carried this title. See Treasury Report, note 8, at 52-54.

V. Analysis of Treasury Concerns

A. Competitive Disadvantage

The Treasury Report opens this section with several examples drawn from its study of approximately 1300 private foundations, noting that it had identified foundations that held controlling interests in as many as 45 business corporations, operating widely diverse enterprises including clothing manufacture, retail stores, printing, hotel management, and real estate.⁷⁸ The Report notes that, while hardly universal, the practice of private foundations holding controlling interests in business corporations was not unusual either. About 180 of the 1300 foundations surveyed by Treasury (about 14%) reported owning at least a 10% interest in one or more business corporations.⁷⁹ Treasury thought this situation generated unfair competition by means of two devices then apparently popular, and by means of two financial advantages, each described below.

1. Devices

a. The Clay Brown Problem

One of these involved the use of private foundations in transactions of the sort that have come to be known as Clay Brown transactions, after the case that first brought this tax avoidance scheme to light.⁸⁰ In these transactions, owners of a business typically sold appreciated stock to a charitable organization, taking back a nonrecourse, no-interest note that called for payments that were, in effect, a percentage of the pretax profits of the business. The charitable organization then would liquidate the corporation, taking ownership of the corporate assets. Immediately thereafter, and as part of a prearranged

⁷⁸ Id. at 30-31 (Ex. 2). (Note that the first three of six examples in the Treasury Report were the ones quoted verbatim in the Senate Report. See text accompanying notes 54-55).

⁷⁹ Patman Report, note 6, at 8, = fb [RS: Double-check pinpoint; can't verify.] = fn found a slightly higher rate in the 543 foundations studied for that report, 111 of which, or about 20%, held interests of at least 10% in corporate businesses.

⁸⁰ Commissioner v. Brown, 380 U.S. 563 (1965). This case was still before the Supreme Court at the time that the Treasury Report was published; however, the Court eventually affirmed the opinion of the Ninth Circuit, so the relevant legal landscape did not change immediately following publication of the report.

plan, those assets were leased to a new corporation formed by the sellers of the now-dissolved corporation. The rent paid to the charity would be set, typically, at 80% of pretax profits of the business; the payment required by the note from the charity to the sellers typically was set at 90% of the rent received from the new corporation.⁸¹

Generally, the note would have a clause that permitted the sellers of the stock to repossess the assets if the charity had not paid the total purchase price by stated dates. Because the total purchase price typically was inflated, there was little risk that the charity actually would want to pay the principal of the note, and become the true owner of the assets. But if the charity were to do so, the artificially inflated price would turn into actual profit for the sellers.

A hypothetical illustration may be helpful in conveying the essence of the Clay Brown transaction form. Suppose a company uses assets worth \$1,000, which have been fully depreciated,⁸² in a business that produces \$125 annually in pretax profits, which in turn generated at the time a corporate income tax (at a rate of 48%), of \$60. As part of a tax-avoidance strategy, the company might purport to sell its assets to a charity for \$2,000, payable under the terms of an interest-free installment note calling for payments equal to 90% of the rental income those assets would generate in future years.⁸³ The charity then would lease the assets back to the corporation, or a successor firm run by the same interests, at a rent equal to 80% of the pretax income of the business. If the pretax income continued to be \$125, the rent would be \$100, of which \$90 would be immediately paid back to the corporation as an installment payment on the purchase money loan. The charity's take from this transaction would be the \$10 spread between

⁸¹ These facts are abstracted from a contemporary and enthusiastic account of these transactions in the tax press. See *Recent Cases Show How Best to Sell a Business to a Tax-Exempt Organization*, 19 J. Tax'n 302 (1963) [hereinafter *Recent Cases*].

⁸² The zero-basis assumption is not essential to the game being played here, but a positive basis would mean that forgone depreciation deductions would have to be considered, an unnecessary complication for present purposes.

⁸³ For reasons not germane here, the sale was usually of the stock of the corporation, which then was liquidated. These steps add nothing to the conceptual analysis of the transaction, however, so I omit them in this simplified account.

its rental receipts and its installment payment obligation.⁸⁴

The corporation's gain from this transaction is that it has generated a deduction for rental payments of \$100, which reduces taxable income to \$25, and tax to \$12. It also would pay a capital gains tax on the installment payments of \$90 (which would be pure gain in the case where, as assumed here, it had no remaining basis in the assets it sold); but under the rules of the time, even corporations were taxable only on one-half of their long-term capital gains (or, more typically, their 1231 gains). So the capital gains tax on the \$90 installment payment was \$21.60. The total payments of ordinary tax, capital gains tax, and net transfer to the charity were thus \$12 + \$21.60 + \$10, or \$43.60, a savings of more than a quarter of their tax liability, compared to what they would have paid if they had had the same earnings without the sale-leaseback through a charity. It was in this tax savings that the unfair competition was thought to lie.

This device is patently abusive,⁸⁵ but it also seems that Treasury could have come up with dozens of better ways to combat it than the excess business holdings tax. To begin with, the excess business holdings approach is obviously insufficient, since nothing in this device required that the charitable party be a private foundation. Indeed, some commentators suggested that the ideal charitable party would be a church, because the unrelated business income provisions were more generous in applying the rules regarding debt-financed property in the case of churches than in other cases.⁸⁶ But at the same time, the excess business holdings approach is overbroad, denying private foundations the opportunities to make investments of their choice even in circumstances that involved no scintilla of Clay Brown abuse. Mostly, though, one is struck by the large number of better approaches available if combating this device is the primary goal.

⁸⁴ Note that no down payment on the installment note typically was required, and, of course, there would be no institutional liability for repayment of the principal of the note, since it was a nonrecourse obligation. Nor was much required in the way of management of the assets, physical possession of which never left the premises of the business. The charity simply cashed checks representing the modest difference between its entitlements and its obligations, as payment for its role in facilitating the transaction.

⁸⁵ The Supreme Court in *Clay Brown* itself did not see it that way, or in any event thought that to the degree that it might be abusive, it was up to Congress to close the loopholes. *Commissioner v. Brown*, 380 U.S. 563, 572, 578-79 (1965).

⁸⁶ *Recent Cases*, note 81, at 303, makes this suggestion.

Indeed, in time, Congress enacted a number of provisions apart from the excess business holdings rules to defeat the Clay Brown device. The most directly applicable is the amendment of the unrelated business income tax (UBIT) exceptions in ' 512(b)(3)(B)(ii), which denies the UBIT exception for rental income in cases where the determination of the rent depends in any part on the income or profits derived from use of the property. This means that the classic Clay Brown pattern now would insert a UBIT liability in lieu of the corporate tax liability that the scheme is designed to avoid, lessening to that degree the amount that the charity would be able to pass through to the sellers of the stock in the form of installment payments on its note. The tightening of the debt-financed income rules for UBIT purposes under ' 514, and the time value of money rules applicable to below-market-rate loans under ' 7872 also would complicate the arithmetic of Clay Brown schemes to a degree that almost certainly would extinguish their viability. In short, the desire to control Clay Brown transactions did not provide a solid justification for the excess business holdings rules at the time of the latter's enactment; and it provides even less justification today, in the light of subsequent, and more effective, amendments to the Code.

b. The Retained Earnings Problem

In addition to the Clay Brown device,⁸⁷ Treasury also was concerned about the scenario in which a foundation would purchase business assets and then lease those assets to an operating subsidiary of the foundation. The rental payments for the leased assets would be set intentionally at above-market levels, so as to minimize taxable corporate income. This arrangement effectively permitted a foundation to engage in an unrelated business without the burden of the UBIT, since the income came to the foundation in the guise of rental payments, which generally were exempt from that tax.

Oddly, Treasury appeared to be relatively untroubled by the loss of the potential UBIT revenue involved in this situation; rather, their concern focused more on the possibility that this device could be used to expand the business through faster

⁸⁷ It actually was described first in the Treasury Report, note 8, at 31, prior to the discussion of the Clay Brown pattern.

accumulation of, in effect, retained earnings (albeit at the foundation level rather than at the level of the operating subsidiary), since those earnings would be undiminished by either an ordinary corporate income tax on the subsidiary or the UBIT on the foundation. Therein lay the competitive advantage over profit-seeking firms in the same industry, which would have to meet their capital needs without the assistance of tax-free retained earnings accounts.

It would seem that such situations would present a reasonably straightforward case for application of ' 482, which grants the Commissioner broad powers to restate income and expense items between or among related entities if necessary to accurately reflect income. After all, the cases that Treasury was concerned about involved businesses that were already in operation at the time the foundation might have acquired the assets. There would be an operating history demonstrating the income-producing potential of the assets, and the conversion of that ordinary business income into inflated rent paid to the foundation normally would have been quite transparent.

And one notes again, as in the Clay Brown situation, that Treasury's solution suffers from both under-breadth in that the device is open on equal terms to all charitable entities, not just private foundations and over-breadth in that the excess business holdings rules seem unreasonably matched to the problem they are intended to correct, if they are to be justified primarily as a means of closing an abuse that involves nothing more complicated than a misstatement of the fair rental value of assets. Controlling this device, as with the Clay Brown device, simply does not require any sort of excess business holdings rules.

2. Financial Advantages

Closely related to this device issue was another, more general aspect of unfair competition that concerned Treasury. The report argued that private foundations enjoyed two financing advantages not available to profit-seeking competitors: First, "because contributions to foundations may be deducted . . . capitalization of foundation businesses

is accomplished with tax-free dollars rather than after-tax dollars.⁸⁸ Second, because foundations apparently were willing "to defer indefinitely the realization of profits from their commercial operations,@they were freer to reinvest profits in expansion of those businesses than would be a corporation whose stockholders demanded current dividend distributions.⁸⁹

Just as in the case of the Adevice@ concern, these arguments are subject to question even in the light of conditions prevailing at the time of the Treasury study. It is true that exempt entities (whether or not private foundations) generally receive their capital contributions in pretax forms. But that observation ignores one vital aspect of this financing: It is a contribution, not an investment; the donor must part with the economic value, with no continuing ownership, and no expectation of future returns. It is far from self-evident that it is easier to persuade people to *give away* money on a pretax basis than to *invest* it on an after-tax basis; indeed, one normally would presume the contrary.⁹⁰ In fact, one of the major scholarly contributions to the economic literature explaining the role of tax rules in supporting exempt organizations develops, quite convincingly, and quite contrary to Treasury's analysis, the following propositions: (1) The inability of charitable organizations to issue shares conveying ownership of the enterprise greatly disadvantages such organizations in capital markets; and, (2) this disadvantage will lead to inefficient capital allocation between the for-profit and exempt sectors, unless charitable organizations are subsidized through exemption from the corporate income tax.⁹¹

The suggestion that corporations owned by foundations were financially favored by their shareholders' presumed willingness to forgo dividend returns is also questionable.

⁸⁸ Treasury Report, note 8, at 32.

⁸⁹ *Id.* at 33.

⁹⁰ Of course, before the 1969 Act, one could say that a gift to a private foundation in some circumstances did not represent the same passage of value to charitable purposes that it does today. The point is that rules regarding self-dealing and minimum distribution requirements are in themselves sufficient at this point to permit us to say that, after 1969, a gift to a private foundation truly does require the donor to part with substantial economic value. That parting will tend to make donations less attractive from a purely self-interested perspective than transactions that involve investing that capital in a way that would produce financial returns.

⁹¹ Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations From Corporate Income Taxation*, 91 *Yale L.J.* 54, 72 (1981).

Even in the 1960's, many individual shareholders strongly preferred *not* to receive dividends, since dividends were taxable at the time at marginal rates of up to 70%.⁹² And, in any event, the market for new stock offerings generally has been readily available to meet the new equity capital needs of those corporations whose shareholders did prefer current dividend distributions.

Of course, the major change on this point since the Treasury report was written was the imposition of minimum distribution requirements in the 1969 Act itself. Now that foundations must distribute for charitable purposes an amount equal to at least 5% of their assets each year, they are presumably among the shareholders *most* interested in current dividend distributions, since dividends are only lightly taxed to foundations, and provide liquidity with which to discharge their statutory distribution obligations.⁹³

Whatever conclusion one reaches on whether Treasury's concerns were well-founded, one final point on the "competitive advantage" issue should be recalled. In its analysis of this point, Treasury was concerned only with *direct* ownership of corporate stock by a foundation. The leasing advantage described earlier in this Subsection, for example, only generates an advantage if the foundation actually owns the shares of the corporation in question; if an individual taxpayer actually owns the relevant shares and thus the foundation owns them only constructively, then the incentive to engage in the UBIT-avoidance device simply does not exist. Similarly, the concern about the alleged advantages of raising pretax donated capital, even if valid, only applies if the capital is indeed coming from the foundation. If it comes instead from individual taxpayers who own their shares personally, but whose holdings are attributed to the foundation, there

⁹² For all domestic corporations in 1965, fully 57.1% of corporate profits were retained by the corporation, rather than distributed as dividends. U.S. Census Bureau, Statistical Abstract of the United States 481 tbl.730 (91st ed. 1970). The percentage of retained earnings actually has declined in recent years to a little over 40%, for a variety of reasons, including the increased participation in equity markets by pension funds, which of course are not taxed on dividend income. See U.S. Census Bureau, Statistical Abstract of the United States 565 tbl.902 (118th ed. 1998) [hereinafter 1998 Statistical Abstract].

⁹³ Section 4940(a) imposes a tax of 2% on net investment income, which ' 4940(c)(2) defines to include dividend income. In most cases, foundations can qualify for a reduction in even this modest rate of tax, to just 1%. See IRC ' 4940(e).

will be no charitable contribution deduction, and that capital therefore will be after-tax capital.

Thus, it is quite clear in this area that only direct ownership conceivably can create the competitive advantage problems that Treasury was concerned about. And those problems can exist only if that direct ownership percentage is quite high. The Treasury Report put that percentage at 20%, apparently on the reasoning that foundation ownership percentages below that number would not create the incentives to avoid UBIT, nor any significant advantage in seeking pretax investment capital.

B. Self-Dealing

Concerns about self-dealing were prominent in both the foundation involvement and the family use sections of the Treasury Report.⁹⁴ At the outset, it is worth noting that the background of such concerns was a regulatory framework that did not then include the self-dealing excise taxes imposed since 1969 by ' 4941. Presumably, those rules do much to allay concern about acts of self-dealing between a foundation and its disqualified persons. It would be hasty to conclude, however, that, with ' 4941 in place, there no longer can be any legitimate concerns about self-dealing. Indeed, the Treasury Report reflects concerns with a softer sort of self-dealing, which might not be easily constrained by rules such as those in ' 4941.

The first set of questions raised by the Treasury Report might be called the "personal network" issues, as to which Treasury's concern was that the corporate business might be inappropriately pressed, for example, to hire the friends and relatives of the foundation managers.⁹⁵ While this can raise some troubling questions, it also raises again

⁹⁴ Treasury Report, note 8, at 34-35 (foundation involvement), 40-41 (family use).

⁹⁵ One can visualize this most easily as something of a Frank Capra movie, in which a small town is dominated by a single manufacturing company, whose stock is owned by one of the town's families. If there are a limited number of summer jobs to be had at the plant, one imagines that family members would have the first chance at landing them, followed by the children of the lawyers, bankers, doctors, dentists, country club friends, and the like, who are most closely networked with the controlling family. Certainly this pattern or its variants still exists, and it is not a particularly attractive feature of American society (or any other society, for that matter, since this is hardly a uniquely American scenario). The point in this context, however, is simply that the excess business holdings rules are unlikely to have much impact on this problem;

the issue with which the previous Section concluded: Is it actual ownership of the corporation by the foundation, or merely constructive ownership through attribution of stock that is actually owned by the foundation's disqualified persons that is the problem? In the latter case, it would seem that foundation ownership of some stock in a corporation controlled by the foundation donors adds little to the potential for conflict that exists whenever a family or a few individuals own a controlling interest in a corporation. If a family were to own 20% (or 50% or 80%) of the stock of a corporation, would it matter whether a foundation also owned some substantial percentage?

In addition to concerns about networks of personal influence, the Treasury Report identifies some instances in which the interests of foundation managers, corporate managers, and the individuals who might be in control of both, may come into conflict. One of these--corporate dividend policy--has been mentioned already, and is discussed more fully below.⁹⁶ Among the other questions are: Will the foundation be vigilant about controlling the corporation's executive compensation and expense accounts if the very people whose compensation and expense accounts are at stake control the foundation? Will the foundation be too willing to tolerate poor performance? Will the foundation commit its funds--which are supposed to be held for charitable purposes--to poor investments in corporations that ultimately are destined to fail?

These problems are of course likely to be more common, and particularly acute, in the context of a closely held corporation. But, like the personal network problems, it is not clear that the substantial presence of a foundation among the shareholders of the company makes them worse. Closely held concerns frequently wish to have generous compensation packages, for example, for officer-shareholders, as a way of reducing the double taxation of distributed corporate profits, and the court reports are accordingly full

whether the family holds the stock directly, or through a private foundation through which its preferences still can be felt, the network will remain intact. And even if the stock of such a corporation becomes widely and diversely held, it would be a mistake to think that there would not still be advantages to being well-connected; it simply would mean that the advantages would accrue to those who were well-connected with the senior management of the corporation, rather than to its shareholders.

⁹⁶ See text accompanying note 90 and Section V.D.

of reasonable compensation cases brought by the Service to combat this problem.⁹⁷ No doubt this case-by-case approach is less than completely effective, but the question in this context is whether the problem is worse because a foundation owns a substantial percentage of a corporation's stock.

Perhaps it is worse in extreme cases. If a corporation's management in effect is stripping value from its shareholders, and one or more shareholders is a foundation, then some of that value is coming at the expense of the charitable activities that the foundation otherwise would support. Even here, however, there may be less to this abuse possibility than meets the eye. If the corporation in question generally has had relatively high salaries and relatively low profits, then the value of its stock--and the measure of any charitable contribution deduction--will be relatively low as well.⁹⁸ But whatever the value of that stock is, after the 1969 reforms, 5% of it still must be devoted annually to charitable purposes. Thus, taking the mandatory distribution requirement into account, the reasonable compensation problem seems to be more an abuse of the business expense deduction than of the charitable contribution deduction.

With respect to foundation managers' incentives to be wise investors, judgments frequently seem to be clouded by a hindsight fallacy. The Treasury Report itself contains examples of foundations that tolerated increasing losses sustained by a corporation that it controlled.⁹⁹ But what does "tolerate" mean in this context? It may mean failure to discharge management. But such discharges are not invariably indicated; management

⁹⁷ See, e.g., *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-48 (9th Cir. 1983), for a good statement of the factors currently in use to determine the reasonableness of compensation. But see *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833, 834-35 (7th Cir. 1999), for a scathing attack on these factors. Note also that the temporary 15% rate on most dividend income, IRC ' 1(h), may change the dynamics of the excess compensation problem in some situations.

⁹⁸ The Treasury Report discusses one such case, *Pullman v. Commissioner*, 23 T.C.M. (CCH) 1310 (1964), in which the Tax Court, in Treasury's view, did not sufficiently discount the value of stock contributed to a private foundation. See Treasury Report, note 8, at 39-40. In *Pullman*, the corporation in question had large accumulations of unpaid preferred stock dividends, and a low historical rate of dividend payments. While the outcome in any particular case may or may not have been sound, a general point to be noted here is that dividend history does not seem to have a great influence on current stock values: Many firms with very large market capitalization--Starbucks, for example--have never paid any dividends at all.

⁹⁹ See, e.g., Treasury Report, note 8, at 35 (Ex. 17) (involving a four-year history of generally escalating losses.)

may be performing well under unavoidably difficult conditions, perhaps due to new foreign competition, changes in technology, or the like. If that is the case, perhaps tolerating losses means simply failing to sell that stock and buy an interest in some other company with better prospects. The fallacy with that reasoning, however, is that if a firm is in difficulty, the value of its stock surely will have declined already. The efficient market hypothesis holds that the stock price at all times reflects all the information that is known to the market about that firm, and about business prospects generally.¹⁰⁰ From that depressed level, the stock price is about as likely to rise again as it is to fall further. *Retrospectively*, it is always easy to say that the foundation managers should have known that losses would continue to accumulate, and that the business ultimately would fail. But the managers in good faith can have viewed the situation as one in which there were some causes for optimism, so that liquidating an investment when its market value was depressed would have been precisely the wrong thing to do.¹⁰¹

So the fact that foundations sometimes make, or retain, investments that ultimately turn out poorly is not particularly convincing evidence of deep structural problems. All investors of significant wealth, upon historical review of their investment decisions, could identify ones that are cause for regret. Regret of this sort is part of the human condition, at least for the branch of the species that makes investments.¹⁰²

¹⁰⁰ For an excellent (and concise) explanation of the efficient market hypothesis, see Richard A. Posner, *Economic Analysis of Law* ' 15.4, at 451-52 (6th ed. 2003).

¹⁰¹ The post-1969 lore of the excess business holdings rules contains one particularly prominent example that, in my view, reflects the hindsight fallacy. Apparently, the B. Altman Foundation held at one time an amount of stock in the B. Altman corporation that exceeded the statutory limits. Nearing the end of its five-year divestiture period under ' 4943(c)(6), it sought an extension. The extension was denied and the foundation diversified its portfolio. Subsequent analysis showed that the diversified portfolio conspicuously outperformed the original portfolio, with its high B. Altman holdings, which the foundation presumably would have continued to hold had its efforts to obtain an extension been successful. At the time the portfolio was diversified, however, the market value of the B. Altman stock was precisely equal to the value of whatever investments replaced that stock in the portfolio. Those market values most definitely would have taken into account the market's view of the future success probabilities of the firms whose stock constituted the respective portfolios. Only with the benefit of hindsight can one say that the foundation was fortunate to have been compelled to diversify. Other foundations, such as the Lilly Endowment and the Robert Wood Johnson Foundation, have done very well with nondiversified portfolios consisting largely of stock of Eli Lilly and Johnson and Johnson, respectively. [RS: Is there anything you can cite for both parts of this note?]

¹⁰² For those who are inclined to be regretful, even successful investments can be cause for regret: One

It might be argued, however, that whether the investment decisions of foundation managers prove to be good or bad, they may be subject to a particular kind of moral hazard, which the following hypothetical example illustrates: Suppose the assets of a business could be liquidated today at a value of \$400, or allowed to remain in a risky business that might be worth \$1,000 one year from now (with a probability of this outcome of 30%), or worth nothing one year from now (with a probability of 70%). The expected value of the outcomes is $(.3 \times \$1,000) + (.7 \times 0)$, or \$300.¹⁰³ A disinterested, risk-neutral investor would choose to liquidate. An investor who is also a manager of the corporation, however, might be influenced by the fact that her salary of \$200 would be paid if she chooses to continue to operate the business, but not if the business is liquidated.

Ultimately, however, this is not really a problem of foundation ownership of business; it is an instance of a more general problem of agency costs. Corporations, especially very large ones, are commonly managed by people whose interests diverge at some points from the interests of their shareholders.¹⁰⁴ One might well ask in the hypothetical case described in the previous paragraph whether it would really help very much if a foundation sold its substantial holdings in such a corporation to diverse investors in the market. It seems doubtful; the managers would continue to have an interest in keeping their fears about the company's outlook to themselves, continuing to draw their salaries for as long as they could, while posting their resumes in whatever venues might lead to the best exit opportunities.

berates oneself for lacking the foresight to buy a larger stake in the winning enterprise.

¹⁰³ Of course, if this probability space became perspicuous to the market, the presumed liquidation value of \$400 would promptly fall to \$300; an implicit assumption of this scenario therefore must be that the manager in question possesses some inside information about the outlook for the firm that has not yet been reflected in the price of the firm.

¹⁰⁴ This observation has been commonplace at least since 1932, when Adolph Berle and Gardiner Means published *The Modern Corporation and Private Property*. See discussion in text following note 110.

C. Distraction of Foundation Management

This section of the Treasury Report is quite brief, confined largely to a single paragraph.¹⁰⁵ The argument is simply that the managers of foundations that own businesses are compelled to spend much of their time and attention tending to the oversight of those business enterprises. Recognizing that the pre-eminent contribution of foundations to the charitable sector lies in their ability to identify (and then to fund) "new approaches, the exploration of uncharted areas,"¹⁰⁶ Treasury wondered whether that function can be performed adequately if the foundation managers also must supervise significant business activities.

This argument sounds plausible, but it ignores several aspects of how foundationsBand, for that matter, business corporations--typically are managed. As some observers have noted, at least in relatively large foundations, there are separate departments charged with monitoring investment performance, so that the executives in charge of charitable programs need not be distracted in this way.¹⁰⁷ It is also true that owning stock in corporationsBeven in amounts constituting control of the corporation--is not the same thing as managing a corporate business. Indeed, shareholders are twice removed from the direct management of the corporation: Shareholders elect directors; directors hire and oversee executives; and executives manage the business of the corporation, including development of strategic plans, deployments of assets, personnel policies, and the like. For the most part, it is neither necessary nor desirable for shareholders to become involved in the management of the corporation to the point of distraction from their other, nonshareholder activities.

If there is any salience to the distraction argument, it would seem to apply only in the situation where the foundation actually, not constructively, controls the corporation. Actual control of a corporation arguably demands somewhat higher levels of stewardship than investments constituting a minority interest. (Because the minority investor has no

¹⁰⁵ Treasury Report, note 8, at 35-36.

¹⁰⁶ Id. at 35.

¹⁰⁷ See, e.g., Simon, note 2, at 162.

power to compel the corporation to do much of anything, there is not much point in thinking about what one *might* compel the corporation to do if one could.) Mere constructive control by a foundation would not seem to raise a distraction problem at all. For that reason, the use of attribution rules, which add the foundation's shares to those held by their disqualified persons, seems quite inappropriate. And, of course, it should be remembered that the Treasury Report itself specifically rejected the use of attribution rules to deal with the foundation involvement problem.¹⁰⁸ The authors of that report had in mind situations in which the foundation actually would own at least 20% of the voting stock of the corporation. Even if holdings above that level—which, as the report points out, may constitute effective, if not legal control in many cases—cause distraction of management, it far from clear that holdings below that level do. Indeed, it can be inferred from the Treasury Report itself that Treasury thought not.¹⁰⁹

Even if only actual ownership of shares by the foundation is taken into account, it is worth considering whether 20% is the right threshold. The question is really what level of stockholdings is minimally necessary to control a corporation. There can be no uniform answer to that question, since it turns on circumstances that vary widely. In large part, it depends on how cohesive the other stockholders may be. If 51% of the voting stock of a closely-held corporation is held by a single shareholder, or multiple shareholders who closely cooperate, 49% will not produce control. Where the other shareholders are dispersed, and do not closely cooperate (conditions that presumably would be typical in a large, publicly held corporation) control of some sort—can be attained with a much smaller holding.

The modern literature on corporate control begins with the publication in 1932 of Adolph Berle and Gardiner Means' landmark study, *The Modern Corporation and Private*

¹⁰⁸ Treasury Report, note 8, at 36.

¹⁰⁹ The Treasury Report addressed this question specifically: "Since effective control of a corporation very frequently resides in a body of stock representing 20 percent of its voting power, and since ownership of a 20-percent interest almost necessarily entails close involvement in the affairs of the business whether or not the interest possesses control of the enterprise, it would seem appropriate to fix the limit at that level." Id.

Property.¹¹⁰ In drastically reduced form, their central point was that large, publicly traded corporations had come by that time to be characterized by a separation of ownership and control, with the shareholders still holding the economic value associated with ownership of the corporation, but no longer controlling it, having ceded such control to the professional managers of the corporation. In Berle and Means' view, this was the substantially inevitable effect of the dispersion of stock ownership that characterized very large industrial corporations.¹¹¹

In developing their thesis, Berle and Means divided control situations into five categories, noting that the lines separating the categories were not sharp.¹¹² The first three categories are of little interest here, since they involve true majority control of the corporation.¹¹³ Berle and Means' last two categories did not depend on legal control, but on a more practical sense of control. They noted that: "Such control is less clearly defined than the legal forms [of control], is more precarious, and more subject to accident and change."¹¹⁴ They divided this practical form of control into a fourth and a fifth category, with the fourth category consisting of corporations controlled by a minority of stockholders acting as such, and the fifth category consisting of those corporations that were not effectively controlled by shareholders at all, but rather by management.¹¹⁵ The line between these last two categories of control is no doubt particularly difficult to draw, especially if some of the managers also hold significant blocks of voting stock. But it is worth noting that, for statistical tables later in the book, Berle and Means placed corporations in the "Minority control" category if they had closely held blocks of stock

¹¹⁰ Adolph A. Berle & Gardiner C. Means, *The Modern Corporation and Private Property* (1932).

¹¹¹ *Id.* at 69. Berle and Means also drew some tentative conclusions about the implications of this insight on the performance of corporations, *id.* at 121-24, but those have proven much more controversial. See, e.g., George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle and Means*, 26 *J.L. & Econ.* 237 (1983).

¹¹² Berle & Means, note 110, at 70.

¹¹³ The categories are, in their terms: "(1) control through almost complete ownership, (2) majority control, [and] (3) control through a legal device without majority ownership." *Id.* The third category refers to the use of things like voting trusts to assemble more than 50% voting control, even in the absence of that level of actual ownership of the stock. *Id.* at 72-80.

¹¹⁴ *Id.* at 79.

¹¹⁵ *Id.* at 80-90.

amounting to at least 20% (but not more than 50%) of the outstanding voting stock, but placed corporations in the Management control category if there were no outstanding blocks of stock amounting to as much as 20% of the stock outstanding.¹¹⁶

The focus of the Berle and Means taxonomy of control situations sharpens markedly when something important turns on whether or not a party to a legal dispute possesses control. One such controversy that sheds light on the question of the minimum holdings necessary to establish working control of a corporation involves the general corporate law principle that selling a corporate office, such as a seat on the board of directors, is a breach of fiduciary duty. But it is ordinarily permissible for the holder of a controlling block of stock to agree, as a condition of the sale of the stock, to allow the buyer of that stock to designate new directors. The theory behind this exception is that the board membership shortly will be altered in any event, so that immediate or anticipatory changes in the board simply accomplish an inevitable result more efficiently. Frequently, the board changeover is done by the seriatim resignation of the seller's directors, followed by the special election of a series of buyer's directors to replace them.¹¹⁷ The leading case in which precisely this was done is *Essex Universal Corp. v. Yates*.¹¹⁸ In a decision to remand the case for further development of facts, Judge Lumbard, writing for the panel, suggested that substitution of directors would be permissible if the block sold was in fact the controlling interest in the corporation, which he viewed as a factual issue to be resolved in each case.¹¹⁹ He further expressed the view that: "Because 28.3 per cent [the percentage of voting stock transferred in this case] of the voting stock of a publicly owned corporation is usually tantamount to majority control,

¹¹⁶ Id. at 93. One wonders if this somewhat arbitrary line chosen by Berle and Means a few decades earlier indirectly influenced Congress's choice in 1969, and the earlier endorsement by Treasury in its 1965 Report, of 20% as the maximum holding of a corporation by a private foundation.

¹¹⁷ The seriatim format assures that, even if the board is closely divided, the parties selling and buying the controlling interest always will have a majority of the board.

¹¹⁸ 305 F.2d 572 (2d Cir. 1962).

¹¹⁹ Id. at 579.

I would place the burden of proof on this issue on . . . the party attacking the legality of the transaction.¹²⁰

Judge Friendly concurred in the remand on this case, but disagreed with Lumbard on the issue of minority control. Because of the difficulties of knowing when a minority interest could really be in control, Friendly would have limited agreements about changing membership on the board exclusively to those cases where an absolute majority control was transferred.¹²¹ He noted that: A[U]nless the seller has nearly 50% of the stock, whether he has >working control= can be determined only by an election; groups who thought they had such control have experienced unpleasant surprises in recent years.¹²² Even the existence of control at any moment in time can be difficult to ascertain definitely. Continuation of control over time is even more in doubt, since a proxy fight, or a hostile tender offer, is always a possibility if the performance of the corporation disappoints investors.

Two trends that were barely under way in the 1960's, but are now fully developed, exacerbate the uncertainties of sub-majority control. First, institutional investors, including pension funds, mutual funds, insurance companies, and others, are very significant participants in equity markets, and hold an increasing share of the total outstanding equity offerings.¹²³ This is crucial in corporate control questions because a small block of stock can maintain control only if the other interests are very widely dispersed, and preferably in the hands of individuals who are not professional investors. In that case, the other shareholders have no effective means of communicating with each other, so a small stockholding, once it gets control of management and the proxy system, may be able to maintain that control. But if the managers of a few mutual or pension funds, in the course of a few phone calls, can talk to the other owners of significant

¹²⁰ Id.

¹²¹ Id. at 581.

¹²² Id. at 582.

¹²³ In 1965, pension funds, mutual funds, and insurance companies held only 12.1% of outstanding equity investments; by 1997, that percentage had increased to 45.7%. Author calculations based on Historical Statistics of the U.S. Colonial Times to 1970, at 987 ser. X 379-92 (1975); 1998 Statistical Abstract, note 92, at 528 tbl.832.

stockholdings, it will be much more difficult for a small stockholder to achieve stable control of a corporation.

The second factor making it harder to control a corporation with only a small percentage holding is the expansion of merger and acquisition capabilities of investment banks. It is now much easier to mobilize large blocks of capital to make tender offers, or otherwise to contend for the control of a corporation. Hostile takeovers of multibillion dollar corporations, once unheard of, are now commonplace. And, clearly, the smaller the controlling block of stock, the more vulnerable a corporation is to this sort of takeover.

So the present circumstances suggest that the Treasury Report may have had this about right: An actual 20% holding may well constitute a controlling interest in a large corporation,¹²⁴ and, in any event, may constitute such a major holding in that corporation that the 20% holder will likely pay more attention to the business affairs of that corporation than may be healthy in the case of the managers of a foundation. Stockholdings below that level seem less problematic.

D. Delay in Benefit to Charity

The Revenue Act of 1950 took a first step toward requiring foundations to distribute their income currently, rather than accumulating it indefinitely. The rule enacted then penalized foundations that unreasonably accumulated their income.¹²⁵ That provision was of limited effectiveness for a number of reasons, but one contributing reason was the ease with which a family foundation could use stock of a family corporation to avoid the application of the rule: If the corporation reinvested its profits rather than distributing them, there would be no income for the foundation to accumulate, and hence no unreasonable accumulation of income.¹²⁶

¹²⁴ Note that smaller corporations, and closely held corporations of any size, are likely to require much larger percentages of ownership to achieve control, because the number of shareholders of such firms is smaller, and more easily mobilized.

¹²⁵ Revenue Act of 1950, Pub. L. No. 81-814, ' 321, 64 Stat. 906, 954-56.

¹²⁶ Of course, the corporation itself might be exposed to the accumulated earnings tax. IRC ' ' 531-537. As long as reasonable business expansion opportunities existed for such a business, however, there was little risk that an accumulated earnings tax would be assessed. See IRC ' 533.

That possibility no doubt contributed to the sense in 1965 that foundation ownership of stock was troublesome, and could be used to defer the use of private foundation resources for charitable purposes. The assault on this deferral problem in the 1969 legislation was vastly more thorough and effective. After 1969, a foundation still could be fully invested in "growth stocks" paying no dividends whatever; indeed, this would have been a highly successful strategy during the late 1980's and 1990's. The foundation nevertheless would have to meet the minimum distribution requirements of ' 4942 or face stiff penalties. If the foundation in fact had neither investment income nor new gifts, then presumably it would need to meet its minimum distribution requirements by either borrowing cash or selling some of its portfolio investments. In any case, however, the minimum distribution requirement effectively assures that the reasonable minimum economic return on the capital owned by private foundations, as determined by Congress in setting the 5% minimum distribution requirement, is distributed for charitable purposes annually.

There are a number of responses to this assertion that sometimes are offered. First, Treasury expressed the view that, even if adopted, the mandatory distribution requirements might not go far enough. Treasury thought that foundations needed "sufficient independent command over their assets to enable them to realize . . . the means to exceed the minimum when their charitable objectives demand it."¹²⁷ This may be a bit unrealistic. Even with the current excess business holdings rules in place, foundations generally operate with a sense that preserving capital for future charitable uses is the appropriate operating principle, and accordingly do not distribute much more than they have to. This is particularly the case with large foundations. In 1999, nonoperating foundations with assets in excess of \$100 million (which hold about 62% of all foundation assets), distributed only about 11% more than their legal minimums--the equivalent of a 5.5% distribution rate.¹²⁸

¹²⁷ Treasury Report, note 8, at 41.

¹²⁸ Author calculations based on Melissa Ludlum, *Domestic Private Foundations and Charitable Trusts*, 1999, IRS Stat. Income Bull., Fall 2002, at 137, 147 fig. H. For all private foundations, the equivalent

The Treasury Report also expresses concern that, if foundation managers are unduly attentive to preserving the (unproductive, by assumption) stock of a family corporation, they may sell off other foundation assets first to meet the minimum distribution requirements, or may meet their minimum distribution requirements by having the original donor use the foundation "as a conduit for his ordinary annual charitable giving--while charity continues to derive no benefit from the foundation's family corporation stock."¹²⁹ The first of these objections goes to the conflict-of-interest point discussed above.¹³⁰ The second abuse is really not an abuse at all. A taxpayer who covers his foundation's mandatory distribution requirements out of new contributions has made additional value available for charitable purposes, and has permitted the foundation to maintain an asset base on which the following year's mandatory distribution amount will be computed.

In addition to the concerns expressed in the Treasury Report, some commentators question the adequacy of the 5% distribution rate imposed by ' 4942.¹³¹ While this issue is somewhat beyond the appropriate borders of this Article, it is worth a paragraph or two here, because it frequently underlies or contributes to deeper concerns about the adequacy of the regulatory framework under which private foundations operate. There is in fact ample reason to believe that a 5% rate does adequately assure that the economic benefit of foundation capital is being devoted to charitable purposes.¹³² Economists over the years generally have regarded the risk-free real rate of return on capital as being around 2%-3%.¹³³ We are accustomed to *nominal* rates that are well above that level, but that is so only because nominal rates reflect market expectations of inflation. But it is reasonably

payout rate was about 6.9%. *Id.*

¹²⁹ Treasury Report, note 8, at 41.

¹³⁰ See Section V.B.

¹³¹ See, e.g., Gaul & Borowski, note 15, at 162-63.

¹³² A somewhat different point is the question of whether allowing a foundation to count administrative costs against its mandatory distribution requirement vitiates the effectiveness of the requirement. This point too is beyond the scope of this Article, but a few preliminary thoughts on the appropriateness of limiting the crediting of administrative expenses against the mandatory distribution requirements are offered in Section VII.

¹³³ See, e.g., John A. Carlson, Short-Term Interest Rates as Predictors of Inflation, 67 *Am. Econ. Rev.* 469, 471 (1977), which found that real interest rates had varied narrowly around a 2.5% rate from 1953 to 1975.

clear that the mandatory distribution rate should be based on *real* rates of return rather than nominal ones, unless the purpose is to phase foundations out of existence over the long run by denying them the opportunity to maintain the real value of their endowments in the face of inflation. Thus, in an economy with a 4% inflation rate, if a foundation begins a year with assets of \$100, and earns \$7 over the year, it really needs to close the year with assets of \$104 to have the same capital base it had at the beginning. If it must distribute \$5, it will have only \$102. In this way, the rules of ' 4942 actually do somewhat overestimate the real return available in the economy, and, in the very long run, should lead to a diminution in a foundation's real assets. Increasing the payout rate would accelerate--unduly, it would seem--this process.

In fact, most foundations have found that their asset bases have grown in recent years (possibly excepting the last two or three)--even in inflation-adjusted terms, and even with mandatory distributions--because of the remarkable run of stock price increases since the mid-1980's, which has been tempered only slightly since the several indexes have receded from their peaks since 2000. Perhaps, in due time, economists will pronounce that a by-product of the information age (or whatever historians will come to call the current era) is that real rates of return are permanently higher. At that time, but not before, it would be appropriate to revisit the question of whether the 5% mandatory distribution requirement is sufficient to allocate currently to charity all of a foundation's real income from its investments.

E. Maintenance of Control

The Treasury Report expressed concern that gifts (presumably especially testamentary ones) to foundations could be used to maintain family control of a business through the foundation's ownership of stock, under circumstances where the presumed alternative--bequests of the stock to family members--would result in loss of control due to the size of the estate tax obligations. In 1965, this probably did create an abuse opportunity: With no minimum distribution requirement, the family foundation

frequently could simply continue to accumulate wealth and economic power without making any significant benefit available for charitable purposes.

Today, however, the effectiveness of the mandatory distribution requirements means that stock given to the foundation really will give rise to current distributions of the economic return on that stock for charitable purposes.¹³⁴ It remains true that a testamentary gift to a foundation can reduce estate taxes, and help maintain control of a family business. But Congress generally has sanctioned the notion of reducing estate taxes for value passing to charity. And it should be noted as well that breaking up control of family businesses has never been an explicit goal of the estate tax. On the contrary, Congress has devoted a great deal of attention in recent years to the design of rules precisely intended to mitigate any effects the estate tax might have that run in that direction.¹³⁵ The issue of continuing economic power raises a genuinely debatable point, with some arguing that preservation of any significant economic power in a charitable gift situation, even if stripped of its economic return, is objectionable, and should be curtailed. Others would say that the opportunity to retain some elements of control, even while making a genuine transfer to charity of the economic benefits of stock ownership, provides a best-of-both-worlds solution to a difficult problem.

Suffice it to say at this point that Congress' recent activity in this area suggests that its view is closer to the latter pole of this debate. In addition to the rules of ' 2057 (which allow special-use valuation of certain farm and family-business property), the very existence of private foundations, and the deductibility of contributions thereto, testify to Congress' comfort with the idea that donors and their families would retain some economic power. Aside from Congress' viewpoint on this issue, it would seem as a general policy matter that diminishing family control of businesses would be difficult to defend as

¹³⁴ This argument may seem to depend on acceptance of the observations in the previous Section to the effect that the 5% minimum distribution requirement does indeed compel the distribution of the economic return on the asset bases within private foundations. But it does not. If the mandatory distribution requirement needs to be changed, it should be. Imposing excess business holdings requirements would be a poor substitute for such a change.

¹³⁵ The most recent such effort, of course, resulted in the addition to the Code of ' 2033A, the "Family-owned Business Exclusion." The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, ' 502(a), 111 Stat. 788, 847-52 (renumbered ' 2057 and amended in scattered sections of 26 U.S.C.).

an appropriate goal of the tax system: It seems to depend on a sense that family ownership of business across generations is a situation that the law should discourage. While no doubt some commentators would argue that social improvements would follow from such a policy, there is simply no evidence that a majority of Americans would support the idea that policies consciously designed to break up family control of businesses would be desirable.

The possibility that assets of a family foundation could be used to *acquire* control of a business presents a somewhat different question. The scenario that might offer cause for concern would be one that proceeds through the following steps: (1) Some family members make sizable gifts to a private foundation (thereby saving substantial estate taxes). (2) Because of either favorable economic conditions, or shrewd management of investments, the foundation assets grow (despite the mandatory distribution requirements) over time. (3) Eventually, the foundation is in a position to acquire controlling positions in corporate businesses.

It is by no means clear that this scenario presents much reason for dismay. Foundations, university endowments, pension funds, and other nonprofit organizations are all active participants in investment markets, making competition with private investors routine, and generally unproblematic. In the specific scenario outlined above, the foundation has succeeded in expanding its asset base, meaning that its annual distribution requirements for charitable purposes have increased as well. If the foundation then determines that investment in a controlling interest of a corporate business presents an attractive opportunity to further increase the value of the foundation assets, what harm is done?

If, however, Congress nevertheless views this as cause for concern, a solution might lie in rules that resemble the *downward ratchet* rules of ' 4943(c)(4)(A)(ii).¹³⁶ Foundations could be prohibited from increasing their ownership percentages of a corporation beyond some minimal level by new purchases of stock. Conversely, if the

¹³⁶ See discussion of this rule in text accompanying note 34.

controlling interest in a business develops from gifts, testamentary or otherwise, then ownership of the controlling interest would have been created by individuals, not by the foundation itself, and would not represent use of foundation assets to acquire the controlling interest.

F. Imprudent Investments

The Treasury Report, which calls this Section "Trading and Speculation by Foundations,"¹³⁷ raises three concerns about high-risk investment patterns. The first is the obvious one: If the foundation takes risks, it might lose all or a substantial part of its asset base, making it unable, or less able, to pursue its charitable program. The second, a very curious argument indeed, is that if, conversely, the foundation is spectacularly successful (which is made more likely by the higher upside uncertainty of risky investment patterns), the very success of the investment program "make[s] possible both the financial empire building and the severance of a foundation from dependence upon contributors which have been criticized [elsewhere in the Report]."¹³⁸ Finally, pursuit of these more aggressive investment strategies is thought to increase the risk of distraction of the foundation's management from the charitable program of the foundation.

The last of these concerns has been discussed in some detail in Section V.C.; those observations seem equally apt as to the distraction point in this context, and there is no need to repeat them here. The second argument "that very successful investment performances by foundations are cause for concern" seems simply silly in today's environment, though it probably reflected a suspicion of foundations that was more justified prior to the 1969 reforms. With the post-1969 mandatory distribution requirements, increased foundation assets translate directly to increased distributions to charity. Any building of financial empires that results would seem to be a relatively benign by-product of the creation of increased resources for charitable work. And the idea that great success in investing would decrease dependence on contributors seems to

¹³⁷ Treasury Report, note 8, at 52.

¹³⁸ Id. at 53.

misapprehend a basic fact about foundations: They are (and have always been) for the most part independent of additional contributions in any case. They can be and usually are managed in such a way as to preserve their capital. If they receive additional gifts, they can expand their charitable programs; but their existence ordinarily does not depend on such gifts, and in many well-known cases involving large foundations, no significant additional gifts beyond a large, testamentary founding gift, are ever received.

That leaves only the first concern: If assets are put at risk, they may be lost. Certainly when put in this way, this observation does indeed invite serious concern. But consider the following alternative view of the situation: Imagine a world with 100 private foundations, having assets of \$1,000 each, for a total of \$100,000. Imagine further an investment world that offers a variety of safe investments, which guarantee a 5% rate of return, and a variety of risky investments, which have a 15% rate of return, but a 20% chance that the investments will become worthless within a five-year period. If the 100 foundations invest in the safe assets, they will earn a return that precisely equals their distribution requirements; if they distribute exactly that amount, their collective asset base will neither grow nor recede, but will remain at \$100,000. If, alternatively, they invest in the risky assets, 20 of the foundations presumably will fail, having been the unlucky ones that experience the full brunt of the downside risk in these investments. The 80 foundations that survive, however, will have total assets of \$128,841.¹³⁹

The point is a simple one, and not dependent on the particular arithmetic of this hypothetical example. Risky investments typically come with a risk premium in the form of a higher expected value of return, which compensates the investor for undertaking additional risk. That, in turn, can raise the average, and total, rate of return for all foundations. This is not without costs, of course. There obviously would be dislocations associated with the bankruptcy of the foundations that fail. But trying to prohibit risky investments by private foundations, but not public charities, seems to be exactly the

¹³⁹ Each of the 80 foundations will enjoy a 15% gross return, which, if they distribute exactly the statutory 5%, leaves a net increase in their asset values of 10% per year. After five years, this cumulates to an increase of 61.051%, yielding a value per foundation of \$1,610.51. The total value for all surviving foundations would be \$128,840.80.

opposite of what might be most desirable. The public charities—schools, museums, hospitals, soup kitchens, churches—have on-going programs, with direct beneficiaries—one might almost say dependents.¹⁴⁰ The dislocations associated with their failure may be profound. In contrast, private foundations—at least the large majority that are nonoperating, grant-making foundations—are much more fungible. They are, in a sense, the bankers of the charitable sector. While failure of some number of private foundations would have some adverse consequences, the total assets of foundations available to support grant-making is likely to be more important to the charitable sector than the survival of particular individual foundations.

Of course, the line between a risky investment and a foolish investment may be a fine one. And there is clearly a public interest in not having foundation managers waste assets that are to be used for charitable purposes. While the history of the jeopardizing investments rules appears to reflect a concern mostly about risk (margin investments, commodities futures, and the like), it may be that the actual use of the rules is primarily to control foolish investments. Perhaps that is so, but the jeopardizing investment rules are not clearly necessary to achieve that result. More general fiduciary principles would seem to be adequate to regulate a foundation manager who, let us suppose, decided that dropping coins in slot machines was the best way to invest foundation assets.¹⁴⁰

G. Other Concerns

In addition to the concerns expressed by Congress and the Treasury in explaining the 1969 private foundation reforms, there are other concerns that seem worthy of mention in evaluating the utility of the rules in ' 4943 and ' 4944.

1. Diversification

One of those is derived from the observation that both sets of rules, as actually

¹⁴⁰ In this rather fanciful case, the Service probably could sustain penalties based on the idea that this was an excess benefit transaction under ' 4958, since the transaction in question involves little more than the subsidization of the manager's gambling activities with foundation funds.

applied by the Service, tend to encourage diversification of foundation investments. In the case of ' 4943, this effect follows directly from the fact that the excess business holdings rules, when they operate to affect foundation portfolio allocations, almost invariably require a foundation to dispose of stock in which it is heavily invested.

Section 4944 produces a similar effect, albeit less directly. The ruling pattern of the Service is such that they appear to be more likely to approve any particular investment if it is part of a portfolio that is substantially diversified. Indeed, the regulations explicitly refer to the need for diversification of the foundation portfolio as background information relevant to evaluating whether an investment under examination should be considered jeopardizing.¹⁴¹

It might seem that diversification would be desirable in foundation portfolio management, and perhaps the regulation of investments under ' 4943 and ' 4944 can be justified on the basis of their effects in this regard. But that seems doubtful, for two reasons. First, for all the reasons discussed in the immediately preceding Section, diversification among all foundations would seem more relevant than diversification within any single foundation. And, with a universe of over 60,000 foundations, including nearly 5000 having assets exceeding \$10 million, some reasonable level of diversity among the universe of foundations is virtually assured.¹⁴²

Further, if pushing foundations toward more diversified portfolios is a primary purpose of either ' 4943 or ' 4944, it must be observed that the provisions are poorly designed to accomplish that objective. In the case of ' 4943, the language of the disincentive is almost precisely the inverse of what it would be if diversification of foundation assets were the goal. Instead of regulating the percentage of a foundation's assets that could be invested in a particular corporation, it regulates the percentage of a corporation's voting stock that can be held by a foundation. Thus, a foundation that invested 10% of its assets in the purchase of 25% of a small corporation's voting stock

¹⁴¹ In the exercise of the requisite standard of care and prudence the foundation managers may take into account . . . the need for diversification within the investment portfolio (for example, with respect to . . . degree of risk and potential for return). © Reg. ' 53.4944-1(a)(2)(i).

¹⁴² Author calculations based on Melissa Ludlum, note 128, at 159 tbl.1.

would be subject to sanctions, while the same foundation could invest 100% of its assets in acquisition of 2% of a large corporation's voting stock, with impunity under ' 4943.

In the case of ' 4944, the statutory rules do not require any particular diversification as a condition of avoiding the jeopardizing investment excise tax. At most, the regulations, as applied by the Service, may allow that agency informally to induce modest diversification as a price for a favorable ruling or resolution of an audit, in the relatively few cases that might be in the vicinity of a jeopardizing investment situation.

2. Public Pressures

A more serious concern is the possibility that foundation management might turn out to be less effective stewards of corporate assets than other potential investors. In a way, this is almost the opposite of the concern expressed by Treasury in its 1965 report. The concern was that the foundation could be made to serve the interests of the corporation.¹⁴³ But in some ways, it can more easily be envisaged that a foundation (and its hypothetical controlling interest in a corporation) could become the servant of the public, or at least of a well-organized and noisy segment of the public.

The scenario that seems worrisome would be this: A foundation holds a controlling interest in a corporate business that is concentrated geographically, and accounts for a high proportion of the economic output of the city or area in which its operations are centered. The foundation trustees may determine that the value of its stockholdings could be maximized by some significant restructuring--selling the assets of the business, or perhaps the stock, closing an unprofitable operation, relocating the center of gravity of the business to another location, or the like. What is the likely response of individuals who would be, or might be, adversely affected by such a change? Quite possibly, it would be to create as much of an uproar as possible. The state legislature may hold hearings. The attorney general may initiate an investigation. Community meetings may be held, and discussions of boycotts and other consumer actions debated. Labor

¹⁴³ See text accompanying notes 70-77.

regulators may attempt to intervene in an effort to assure that job loss is minimized.¹⁴⁴

Of course, some version of this scenario can occur whenever a corporation considers significant restructuring. But two things are different when private shareholders control the corporation. First, the public, for the most part, ultimately concedes the right of private individuals to dispose of their property in ways that they think best. There is no similar concession in the case of property held by a foundation; many view it as a quasi-public trust to be operated for the general welfare. It has received valuable tax concessions from the public, this argument would go, and has certain obligations derived from that favoritism.

Second, where control of the corporation is privately held, the parties holding that control have a strong and direct financial interest in maximizing the value of the holdings they control. If, under some circumstances, that means that the assets or stock should be sold to an outsider, then those individual shareholders presumably will follow their interests. In contrast, the interests of a foundation's trustees, as trustees, are much more attenuated. They want in some general way to do what may be best for the foundation, but they may not be willing to take much heat from state officials and the general public if the foundation's interests come to be perceived as contrary to the best interests of the community.¹⁴⁵

It is not instantly obvious whether this political rearrangement (that is, of foundations feeling compelled to serve the public interest at the expense of the

¹⁴⁴ This scenario resembles to some degree the situation presented by the exploration of some restructuring options by the Hershey Trust, which controls the chocolate company of that name. In fact, the primary Hershey Trust is not a private foundation, because it operates a school for orphaned children. See Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 Ind. L.J. 937, 987 (2004). And the situation described is very unlikely to arise in the private foundation case, under current law, in large part because ' 4943 makes it unlikely that a foundation would ever control a major corporation. But the point is that this scenario would become more conceivable if ' 4943 were repealed.

¹⁴⁵ The assumption behind this observation is that the trustees in question have no direct financial interests in the corporation controlled by the foundation. If the foundation is merely *deemed* to have control, because of the control held by its disqualified persons, then this scenario is largely inapplicable, because the foundation itself does not have the legal power to control the corporation. If, for example, the foundation actually holds only the 2% control permitted by the current *de minimis* rules, while disqualified persons of the foundation own stock constituting actual control, then those disqualified persons presumably will act like any other individual shareholders in pursuing their best interests as the owners of a corporate business.

foundation's interest) would be a good thing or a bad thing. One certainly could argue that the political pressure a foundation might feel to pursue the general public good, even in cases where that diminishes the value of the foundation's assets, might be a desirable feature in corporate governance. Perhaps, in other words, corporations controlled by foundations might behave better as public citizens than corporations controlled by private individuals.

Perhaps. But such an argument assumes that the political noise raised by labor unions, elected officials, local chambers of commerce, and all the other self-appointed guardians of the public interest, actually does reasonably represent the interests of the general public. But it is far from clear that corporate governance by public uproar necessarily produces the best outcomes, for the foundations, the corporations, or even the communities involved in these situations.

Further, there is likely to be a loss of economic efficiency in situations where public uproar determines whether, for example, corporate assets are retained by their original owner or sold to one who presumably attaches a higher value to them. There is a price in lost efficiency paid when a political process captures a fundamentally economic process.

On balance, one is left with some unease about the idea that corporations might be controlled by foundations. It is quite conceivable that corporations might better perform their functions in our economy if they are not controlled by parties that may be excessively susceptible to public pressure in the ways that foundation trustees frequently may be.

VI. The Costs of Regulating Business Holdings and Jeopardizing Investments

Enforcing the excise taxes on excess business holdings and jeopardizing investments has two clear costs: compliance costs, and the possible loss in value of assets held by foundations, compared to what they might be in an unregulated environment. I consider each of these next.

A. Compliance Costs

1. Section 4943

Compliance costs arise from several different sources. One of those is the cost of resolving ambiguities in the provisions in question. With respect to this factor, the excess business holdings rules do quite well: They are reasonably clear with respect to what levels of holdings have been sanctioned, and foundations ordinarily know that they must avoid acquiring controlling interests in corporate or other businesses, and must divest such interests, subject to some leniency in the grandfathering rules,¹⁴⁶ if they had them when the statute was enacted, or received them by gift or bequest subsequent to that enactment. That is not to say that there are no gray areas in these rules. In fact, the number of rulings published and private letter rulings (including technical advice memoranda) which cite ' 4943 exceeds 1000 in the 34 years it has been part of the Code. Most of these rulings, however, do not involve any substantial excess business holdings issue. Many citations, for example, simply recite as part of the background facts that the terms of a trust instrument explicitly forbid the trustees from acquiring an interest in a business that would violate the excess business holdings rules. When rulings that do not appear to involve any genuine issue under ' 4943 are weeded out, the file of citations that remains contains slightly fewer than 100 rulings.¹⁴⁷ These rulings may involve, for example, questions of whether a particular stockholder was or was not a disqualified person with respect to the foundation, since resolution of that issue bears on the determination of whether enough stock is attributed to the foundation to put the foundation into an excess business holdings situation.¹⁴⁸ Many ruling requests seek extensions of the divestiture periods provided for either grandfathered stock held in 1969, or new stock acquired by gift or bequest after that date.¹⁴⁹ Some involve the possibility that a business may be operated to advance an exempt purpose of the foundation, and as such may be exempt

¹⁴⁶ See text accompanying note 33.

¹⁴⁷ The numbers are presented as somewhat fuzzy in this Subsection, because the line between a genuine issue and mere boilerplate usage of the citation is itself a bit fuzzy.

¹⁴⁸ = fb [RS: provide an example]= fn

¹⁴⁹ = fb [RS: Provide an example]= fn

from the excess business holdings rules.¹⁵⁰

A collection of private rulings amounting to barely three or four per year, as an average over the life to date of these provisions, hardly seems to indicate substantial compliance problems. To be sure, the letter rulings file ordinarily reflects only a small percentage of the legal issues that arise; many such issues are resolved instead by either formal opinion letters, or less formal advice of counsel. Still, even if the number of issues that require serious attention (and correspondingly serious legal expenses) is several orders of magnitude greater than what appears in the collection of private letter rulings file, it still would not be so great as to merit repeal or substantial amendment on those grounds alone.

A more serious source of compliance costs in the excess business holdings area is the cost of actually divesting noncompliant holdings of stock or other assets subject to the rules. The case law surrounding several divestitures necessitated by ' 4943 suggests that these costs are often quite sizable. For example, *Bankers Life and Casualty Co. v. United States*¹⁵¹ involves the rearrangement of the portfolio of the John D. and Catherine T. MacArthur Foundation. John D. MacArthur controlled the insurance corporation that was the named party until the stock constituting that control was transferred after his death to the foundation. In response to the excess business holdings requirements, the corporation distributed substantial real estate investments in its portfolio to the foundation. This presumably was done to reduce the value of the corporate stock, so that the ultimate sale of that stock by the foundation could be accomplished with as little gain, and with as little disposition of the historical assets held indirectly by the foundation, as possible. Unfortunately, the Seventh Circuit found that the corporation did realize gain.¹⁵² As a result, the assessment of some \$71 million of additional taxes against the corporation

¹⁵⁰ See, e.g., Ltr. Rul. 200202077 (Jan. 11, 2002). Excess business holdings are defined as holdings in any business enterprise meeting the statistical tests of ' 4943(c). A Business enterprise is defined in ' 4943(d)(3)(A) as not including a functionally related business.

¹⁵¹ 142 F.3d 973 (7th Cir. 1998).

¹⁵² Id. at 987-88. Section 815(a)(2) makes taxable to the distributing corporation certain distributions to shareholders that are deemed to come from policyholders' surplus. Reg. ' 1.815-2(b)(3) requires that distributions of property be valued at the fair market value of the assets distributed. Bankers Life unsuccessfully challenged the validity of this regulation.

was sustained.¹⁵³

Apart from the income tax exposure that some divestiture actions may occasion, rather ironically, there can be exposure to foundation excise taxes from the very acts made necessary to avoid foundation excise taxes. *Friedman Foundation Inc. v. Commissioner*¹⁵⁴ illustrates how this may occur. The Tax Court in that case found that the sale of stock at a gain did constitute investment income for purposes of the excise tax on foundations investment income under ' 4940.¹⁵⁵ That tax, which at the time was assessed at a rate of 4% of the amount of the gain,¹⁵⁶ operated as a largely unavoidable penalty tax on having historically held excess business holdings, prior to the enactment of the statute that caused them to be excess business holdings.

Another case potentially involving an excise tax incurred to avoid an excise tax was *Continental Water Co. v. United States*.¹⁵⁷ That case involved a foundation that sold a controlling interest in a corporation to another corporation controlled by disqualified persons with respect to the foundation. This was permissible under the transition rules of ' 4943, but only if the sale was for fair market value. The Service asserted that the sale was for less than fair market value in this case, but the foundation prevailed. No doubt at some considerable expense in litigation costs in the Court of Claims. Had the Service been successful, a tax under ' 4941 for impermissible self-dealing would have been sustained.

¹⁵³ Id. at 987-88. One might be inclined to conclude that Bankers Life, or the foundation trustees who controlled its stock, simply made an error in proceeding as they did. After all, they presumably could simply have sold the amount of stock necessary to comply with ' 4943 without making any prior distribution of the corporate assets. Their options may have been quite complicated, however. Because this was a closely-held corporation, much of whose portfolio was invested in real estate, the foundation may have faced some difficult problems in setting an appropriate value for the stock that had to be divested. They may have hoped to avoid these problems by ridding the corporation of the assets that would have been difficult to appraise, and hence would have made the stock itself difficult to appraise. Also, as *Friedman Found. Inc. v. Commissioner*, 71 T.C. 40 (1978), illustrates, sale of stock at a gain is itself a taxable event for the foundation; minimizing that gain if possible by stripping substantial assets from the corporation prior to sale thus seems desirable.

¹⁵⁴ 71 T.C. 40 (1978).

¹⁵⁵ Id. at 53-54.

¹⁵⁶ The current basic rate is 2%, which in some circumstances can be reduced to only 1%. IRC ' 4940(a), (e)(1).

¹⁵⁷ 82-1 USTC & 9300 (Ct. Cl. 1982).

In some cases, a divestiture related to ' 4943 may expose a corporation to possible liability under the securities laws. This was alleged, for example, in *Umbriac v. Kaiser*,¹⁵⁸ involving the Kaiser Foundation, and the corporation whose stock it held, the Kaiser Industries Corporation. Kaiser Industries was largely a holding company, holding stock of partly-owned subsidiaries involved in steel, aluminum, and cement manufacturing, among others. By liquidating, and distributing the stock of its subsidiaries, Kaiser Industries was able to resolve the foundation's excess business holdings problems, because the fractional ownership of Kaiser Industries by the foundation (which happened to be 30.6% at the time of the liquidation) then would be multiplied by the fractional ownership of Kaiser Industries in the subsidiary.¹⁵⁹

The decision to liquidate had to be, and was, approved by a sufficient percentage of the Kaiser Industries shareholders. Following approval and subsequent liquidation, however, a class of outside shareholders sued the liquidation trustee, the foundation, and individual members of the Kaiser family on grounds that the liquidation proxy did not disclose that the distribution of the stock in this manner might forfeit the control premium that Kaiser Industries allegedly held in the stock of its several subsidiaries, to the detriment of all Kaiser Industries shareholders.¹⁶⁰ The defendants prevailed; but even a brief description of the case provides some sense of the disorder, and legal exposure (and expense) that can be involved in divestiture actions involving large corporate holdings.

Of course, for foundations that had excess business holdings exposure at the time of the 1969 Act, the divestiture costs are largely sunk; no conceivable reform of ' 4943 can erase whatever costs were associated with compliance-driven divestitures that already have happened. But ' 4943 predictably will cause divestitures in the future as well, as large stockholders give, at death or inter vivos, controlling blocks of stock in corporations to private foundations. Divestiture costs therefore must be considered as among the

¹⁵⁸ 467 F. Supp. 548 (D. Nev. 1979).

¹⁵⁹ Id. at 551 n.2. For example, Kaiser Industries owned 37.4% of Kaiser Aluminum; after the pro rata distribution of that stock to its shareholders, including the foundation, the Kaiser Foundation owned 30.6% of a 37.4% holding in Kaiser Aluminum, or only 11.4% of the stock of the latter corporation, a sufficiently small ownership that it could avoid excise taxes under ' 4943.

¹⁶⁰ *Umbriac*, 467 F. Supp. at 550-51.

continuing compliance costs of retaining ' 4943, and those costs can be of significant magnitude.

2. Section 4944

In contrast to the excess business holdings rules, which are reasonably free of ambiguity, the jeopardizing investment rules would seem to present serious interpretive problems in two areas. The first set of problems involves the core rule of what is a jeopardizing investment. The second set involves the major exception to jeopardizing investments, namely, the question of what is a program-related investment. It did not help that the legislative history and regulations identified several types of investments that might, or might not, be jeopardizing, depending on the circumstances.¹⁶¹ Nor did it help that the initial ruling position of the Service was hostile to the idea of approving investment programs or patterns.¹⁶² The Service noted in that ruling that the regulations required that judgments about jeopardizing investments be made on an investment by investment basis,¹⁶³ and also made as of the time the investment was made,¹⁶⁴ and from these facts concluded that approval of an investment procedure governing investments to be made in the future is not possible.¹⁶⁵ The message seemed to be that foundations would need to clear each new investment that might be within the suspect categories through the IRS ruling process.

Fortunately, these unhappy expectations were not fulfilled. Though over 1000 private letter rulings since the enactment of ' 4944 do cite that section, the bulk of these are simply boilerplate citations in contexts such as ' 507 termination letters, where the Service simply assures the foundation that it sees no jeopardizing investment problem in the transfer of foundation assets to successor organizations. Of the 60 or 70 rulings that

¹⁶¹ See notes 62-65 and accompanying text.

¹⁶² Rev. Rul. 74-316, 1974-2 C.B. 389.

¹⁶³ Reg. ' 53.4944-1(a)(2)(i).

¹⁶⁴ Id.

¹⁶⁵ Rev. Rul. 74-316, 1974-2 C.B. 389, 390.

actually appear to engage a genuine ' 4944 issue,¹⁶⁶ most are questions about whether an investment can qualify as a program related under ' 4944(c). Usually, the Service agrees that the investment is program related, but not always.¹⁶⁷

Other foundations have sought rulings on whether particular types of investments would be jeopardizing within the overall portfolios that those foundations had or proposed to acquire. In a number of cases involving investments that the regulations make subject to close scrutiny, the Service has said that the investment programs would not be jeopardizing. This has been true with respect to investments in small cap stocks, venture capital enterprises, and distressed securities,¹⁶⁸ oil and gas interests,¹⁶⁹ and commodities contracts.¹⁷⁰ In some of these rulings, it is clear that what the Service was approving was a program of investments of particular types, and not the specific investments in specific contracts or securities.¹⁷¹ Thus, the actual ruling posture of the Service over at least the last decade or so has been, thankfully, somewhat at odds with its initial position that it could rule only on particular investments on a case-by-case basis, and not in terms of an overall, continuing program of investing.

In contrast, investments in high-yield securities,¹⁷² unsecured loans,¹⁷³ and certain asset collateralizations¹⁷⁴ were found to be jeopardizing. And in one rather troubling ruling, the portfolio of the foundation was found to be jeopardizing simply

¹⁶⁶ These rulings are those that involve a genuine ' 4944 issue as opposed to a boilerplate citation to that section, although the line between the two is not always clear.

¹⁶⁷ See Ltr. Rul. 9340002 (June 16, 1993), for an example where the Service did not approve as program-related a foundation's investment in the stock of a hotel corporation, where the corporation was operating a single hotel in a depressed area, the development of which was the primary purpose of the foundation. (Because the foundation owned all of the stock of the corporation, and because the operation of the hotel was found not to be functionally related to the exempt purpose of the foundation, the Service also ruled that the foundation was subject to excess business holdings taxes under ' 4943.)

¹⁶⁸ Ltr. Rul. 9723045 (Mar. 12, 1997).

¹⁶⁹ Ltr. Rul. 9451067 (Sept. 28, 1994).

¹⁷⁰ Ltr. Rul. 9237035 (June 16, 1992).

¹⁷¹ See, e.g., Ltr. Rul. 9451067 (Sept. 28, 1994).

¹⁷² Ltr. Rul. 9210025 (Dec. 9, 1991). = fb [RS: The LR did not specifically find the investment to be jeopardizing, rather refused to rule that it wasn't.] = fn

¹⁷³ Ltr. Rul. 8206076 (Nov. 10, 1981). = fb [RS: This is an incorrect citation; please check] = fn

¹⁷⁴ T.A.M. 9627001 (July 5, 1986).

because the portfolio had not been diversified.¹⁷⁵ The message that foundation investment managers must receive from this is that if they wish to push the edges of their portfolios into the ranges described as suspect in the regulations, they should seriously consider getting a ruling. Alternatively, and more troubling, they may simply abandon the investment idea.

B. Investment Costs

The last notion of the previous Section leads nicely into consideration of the investment costs of the two excise taxes. The argument in this Section is quite simple: By denying foundations the right to make their own judgments about the investments that they might make, the Service may deprive those foundations of the opportunity to earn higher returns. Obviously, it is far from certain that any particular foundation would earn higher returns from an investment pattern that effectively is proscribed by ' 4943 and ' 4944; they might earn higher returns, lower returns, or about the same returns. But there are systematic reasons to believe that higher returns might be possible for foundations overall without the restrictions.

With respect to ' 4944, the reason is simply that risky investmentsBprecisely the ones that ' 4944 discouragesBfrequently offer the benefit of a risk premium; that is, the investment has a higher expected value, along with a more uncertain outcome. As noted previously, if large numbers of foundations engaged in investment patterns that accepted higher levels of risk, but benefitted as well from higher risk premiums, the foundation world overall would have more resources, albeit housed in fewer foundations. On balance, this would be a more than acceptable outcome, since there is positive value in foundations having more assets to invest in charitable activities, but no real costs to a modest consolidation in the overall number of foundations.¹⁷⁶

¹⁷⁵ T.A.M. 9205001 (Sept. 12, 1991). = fb [RS: The ruling lists diversification as 1 of 3 reasons the investment was jeopardizing. Perhaps the text can be changed to A in part@ or A in large part.@]= fn

¹⁷⁶ In 1999, there were nearly 60,000 nonoperating private foundations that filed Form 990-PF. See Ludlum, note 128, at 139. I would not claim that that is too many, but it would seem to be more than the minimum number necessary to assure reasonable diversity within the foundation world, to say the least.

With respect to ' 4943, the obvious cost of precluding controlling ownership of a corporation by a foundation is that the foundation may forfeit as well the opportunity to gain a control premium. This will not invariably be true; a foundation may be given a controlling interest in a corporation, and may be able to sell that interest, or most of it, at a price that reflects the existence of a control premium. But outside of that circumstance, the foundation, because it is precluded from acquiring control of a corporate business by its own hand, also is precluded from acquiring a control premium that may grow in value over time.

C. Other Costs

Two other costs that do not fit neatly within the compliance and investment categories need to be noted. First, it is entirely possible that the investment restrictions, particularly the excess business holdings rules, may discourage charitable giving under some circumstances. Imagine, for example, that an individual has become very wealthy by founding a corporation that has become hugely and quickly successful. (I note in passing that the last two decades have witnessed quite a lot of this sort of thing; despite the reversals of the last few years in the computer and information industries, there are still hundreds if not thousands of multimillionaires at large who are in circumstances roughly approximating the one I am relating here.) Suppose further that the founder wants to retain control of the corporation at least for the remainder of her own life, and, if possible, would like control to remain in the hands of her heirs after her death. Finally, suppose that the founder, having become successful beyond her wildest dreams, has developed a serious charitable agenda, and would be willing to fund that agenda with very sizable charitable gifts.

But from what source would those gifts come? Most of our hypothetical owner-executive's wealth continues to be invested in stock of the corporation she founded. She could sell some of her stock, of course. But that would both incur substantial (and completely unnecessary, in light of the ultimate charitable destination of the values in question) capital gains taxes, and risk the loss of control of the corporation, in some cases,

depending on how close the margin of control was ex ante, and how large the gifts might be. She could give the stock to a private foundation, understanding that they would need to dispose of that stock over a five-year period. That would buy a little time, but still would lead in many cases to the loss of control of the corporation. Or she could give the stock to a public charity that was not subject to the excess business holdings rules. But that would be unattractive both because our founding mother again would risk the loss of control of the corporation (since she would not be in a position to control the public charity's exercise of its voting privileges), and because it would make it more difficult for her to put her own stamp on the charitable program that the donee charity pursues.

The obvious path this taxpayer would like to take is to form a private foundation, make substantial gifts of the stock of the corporation she continues to control, and use the income from that investment to pursue the charitable program that she can direct from the continuing role that she could create for herself in the foundation management. But ' 4943 effectively bars that course of action.

Some might applaud this outcome, on grounds that the desired scenario just described has sufficiently unattractive aspects that it indeed should be proscribed. These critics might object to the attempt to maintain high levels of personal control over the charitable program of the foundation. They surely would object to continued retention of control of the corporation through the use of the foundation. They might object to the possibility that both income tax and estate tax benefits, which ultimately come at the expense of other taxpayers, might be financing much of this.

While these are not trivial concerns, they are ultimately unpersuasive. It must be remembered that private foundations always permit their creators to maintain considerable control over the way in which charitable ends are served. If that is objectionable, private foundations ought not be regulated; they should be eliminated. But that is not the course that Congress has chosen.

Using the foundation's holdings to maintain control over the corporation is obviously something that some find objectionable; but the previous Section examined the reasons for those objections, and found them to be based largely on some combination of

misapprehensions about the dangers of such arrangements, or an anachronistic view derived from the historic opportunities for abuse of private foundations, which did not survive the 1969 Act.

And, as to the income and estate tax benefits associated with the scenario described, it should be noted that the income tax benefits in many cases are illusory, because the individuals of the sort described often have wealth that permits charitable giving far in excess of the income limitations on deductions.¹⁷⁷ Many entrepreneurs have rather modest salaries, at least relative to their wealth, and their companies may pay modest dividends, or none at all. For example, an executive of a corporation may have a salary of \$1 million, but a personal fortune of 100 times that amount or more. If he wishes to make a \$5 million gift to a private foundation, he would be allowed to deduct only \$300,000 of it in the year of the gift, and only \$1.5 million over the five-year period allowed for carryovers.

Of course, the income limitations are not a problem in all cases; many donors to private foundations can and do deduct their gifts. So what? Again, Congress has chosen to permit this form of charity, and to subsidize it with a deduction. If that is an unsound decision, it has implications far beyond the question of how much stock a foundation should be permitted to hold.

Most donors will benefit from a reduction in estate tax liabilities if they make substantial gifts to private foundations, whether at death or during life. The values transferred to the foundation simply will not be in the base against which the estate tax is assessed. But, rather than being an unattractive aspect of the founding mother scenario from a public policy viewpoint, this can be viewed instead as producing a distinctly positive outcome. While estate tax issues have divided the Congress in recent years as few other issues have, one thing that Congress seems to have achieved near-consensus on is the

¹⁷⁷ See IRC § 170(b), which imposes limits on the percentage of the contribution base (roughly, adjusted gross income) that may be deducted as a charitable contribution in any year. In general, that limit is 30% of the contribution base for gifts to private foundations. Section 170(d) allows a five-year carryover of charitable deductions barred by § 170(b), but many people whose deductions are barred within one year are over the contribution limits in other years within the five-year window as well, and so must allow the carryovers to expire unused.

idea that breaking up a family's ability to control its businesses is an inappropriate goal of the estate tax. If a private foundation can help maintain control, while at the same time assuring that substantial value is devoted to charitable purposes, that is an outcome that would be more laudable than lamentable.

Finally, it seems reasonably clear that in many cases, if gifts of large interests in corporations cannot be made to a private foundation, they either will not be made to charity at all, or they will be made in forms that are less subject to the other private foundation regulatory rules, which assure that distributions to charity will be made, and that self-dealing and grant-making will be reasonably policed. A course along the first line of avoidance suggested above would be for the wealthy individual to do little or nothing for charitable ends during life, and to engage in aggressive estate tax avoidance to enable passage of as much value to noncharitable heirs as possible.¹⁷⁸

An avenue of increasing concern along the second line of avoidance would be to give the stock to a "support organization," which behaves in many ways like a private foundation, but is exempt from the private foundation network of rules under ' 509(a)(3). The excess business holdings and jeopardizing investment rules are not the only source of pressure to adopt the support organization format, but they may be decisive for some donors, in some cases. The Service is rightly concerned about this possibility, but it is not clear that the courts share enough of that concern to be helpful to the Service in controlling that abuse. One occasionally sees, for example, casual references to the notion that an organization would be restructured as a support organization, precisely to avoid excise taxes under ' 4943.¹⁷⁹

¹⁷⁸ For example, use of a family limited partnership to hold much of the stock of the corporation, and/or use of grantor-retained annuity trusts to freeze the value of the stock for transfer tax purposes, may be effective enough for the family members to retain control of a corporation under the circumstances described for at least a few generations. See generally Richard Schmalbeck, *Avoiding Federal Wealth Transfer Taxes*, in *Rethinking Estate and Gift Taxation* 113, 132-38 (William G. Gale, James R. Hines Jr. & Joel Slemrod eds., 2001).

¹⁷⁹ See, e.g., *Phillips Exeter Academy v. Howard Phillips Fund, Inc.*, 196 F.3d 284, 287 (1st Cir. 1999).

VII. Conclusions and Recommendations

The implications of the foregoing analysis are obvious, so the conclusions and recommendations should come as no surprise. It is not the case that the rules under ' 4943 and ' 4944 have no benefits; rather, it is a balancing question. Are the benefits worth the costs, in terms of compliance costs and in terms of resources that may be lost to foundations through diminished investment return or diminished charitable giving?

As to ' 4944, the costs seem clearly greater than the benefits, and complete repeal accordingly seems indicated. The provisions are close to being deadwood, but not quite; and, as such, they continue to impose compliance costs, and may chill investment strategies that would be beneficial for foundations as a whole. Repeal would by no means leave foundation investment practices completely unregulated. General fiduciary principles requiring good faith and prudence would continue to apply, just as they do now to public charities. Enforcement of those principles would lie, as it does now with respect to public charities, largely with the attorney general of the state in which the charity was organized. But the Service would not be completely without jurisdiction. In cases involving clear abuse, the Service could enforce minimum standards by asserting that the foundation in question was not organized exclusively for charitable purposes, and withdrawing its exempt status.

The excess business holdings rules are more complicated. As noted, there are some reasons to be concerned about whether foundations are suited to the task of controlling businesses. Because of community pressures of various sorts, they may not be able to deploy the business assets to yield the best returns for the benefit of their programs. And the excess business holdings rules may serve as something of a backstop to the rules designed to prohibit, or at least to regulate, self-dealing and conflict of interest problems.

Even so, some reform seems indicated. It would appear that the limitation of foundation control of business is justified only when the foundation actually is in a position to control the business. The arguments supporting the excess business holdings rules have little salience when the foundation is only *constructively* in a control position due to the attribution to it of the shares held by disqualified persons.

Accordingly, it seems appropriate to do what the authors of the Treasury Report in 1965 proposed to do in the original statutory framework: apply the business holdings rules without the use of attribution rules, so that a foundation, itself, could hold up to, but to more than, 20% of the voting stock of a corporation.¹⁸⁰ The attribution rules were added to achieve a goal that can be best summarized as one that would allow the estate tax, over time, to divest a family from control of its historic business interests. Since that is no longer a legitimate object of the Service regulation of private foundations (if indeed it ever was), continued pursuit of that goal through the use of attribution rules should cease, and those rules should be repealed.

Congress may wish to employ devices like those used in its downward ratchet transition provisions,¹⁸¹ prohibiting foundations from increasing the percentages of a corporation beyond some stated level by new purchases of stock. This would serve to limit the use of foundations to *create* foundation control, thereby distinguishing situations in which a foundation merely continues a control position that otherwise was formed.

It should be noted further that the excess business holdings rules are credited with achieving some goals that probably could be better achieved through other, more direct means. For example, the excess business holdings rules might be thought to prevent a foundation from spending too much of its resources in the management of a business. That potential problem is part of a much broader problem relating to foundations= administrative overhead. Proposals currently under discussion that would prohibit foundations from crediting their administrative costs against their distribution requirements would make it more difficult for foundations to engage excessively in business management activities, and would redress other problems as well.¹⁸² While that particular proposal strikes many foundations as draconian, more modest approaches along the same line have much to recommend them. Perhaps, for example, a foundation could credit its expenses against its distribution requirements, but only to the extent of 20% or

¹⁸⁰ Treasury Report, note 8, at 36.

¹⁸¹ IRC ' 4943(c)(4)(A)(ii).

¹⁸² See, e.g., H.R. 7, 108th Cong. ' 105(d)(1) (2003), which would have disallowed certain administrative expenses from being credited against the 5% minimum distribution amounts.

25% of the mandatory distribution amount in any year.¹⁸³ One could go even further than that, and adopt an excise tax on excess management expenses to discourage foundations from devoting excessive portions of their resources to their own management. The point is that the excess business holdings rules, while possibly having some salutary effects on issues such as management expenses, are quite indirect and incomprehensive in addressing the regulatory objects that Congress and Treasury may have had in mind.

The adoption of any of these suggestions would not hugely change the foundation world. There would be a modest reduction in direct regulatory costs of compliance, and indirect regulatory costs of forgone opportunities. In some cases, a family foundation would be in a position to receive gifts--of stock in a corporation controlled by the same family that created the foundation--that otherwise would not be made at all, thereby increasing the flow of resources to charitable purposes. The costs of the reforms would in all likelihood be negligible; the Service would lose some tools that it does not use very often anyway, and which in most cases cannot be used to achieve any appropriate goals anyway. The time has come for Congress to revisit these 1969 reforms, and reduce the redundancy and regulatory overkill that they cause.

¹⁸³ An even better approach would incorporate a sliding scale of creditable expenses, under which smaller foundations could credit a somewhat higher percentage of their mandatory distribution amount, and larger foundations a somewhat smaller percentage, reflecting presumed efficiencies in operations that should be available to foundations with greater resources.