The Lesser Foundation Excise Taxes: What Are They Good For? (Not Quite) Absolutely Nothing

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Introduction

It is well understood that the private foundation as an organizational form was subject to widespread abuse prior to the Tax Reform Act of 1969.[1] In a typical case, a wealthy individual might establish a foundation through either an *inter vivos* or testamentary gift, obtaining valuable deductions from income or estate taxes. Following that, the settlor or descendants (through their control of the foundation) could simply preserve the foundation's original corpus, accumulate the earnings generated by investment of that corpus, and use those funds as something of a family bank. Perhaps they would cause the foundation to buy or sell property to or from family members, make loans to family members, or allow family members to use physical facilities of the foundation for personal purposes. Because the funds in the foundation were to be held exclusively for charitable purposes, any such transactions were to be accomplished at fair market values. However, that principle was often difficult to enforce, and was widely disregarded. The foundation world in the pre-'69 era has been described as "a metaphoric wild west, but with a Park Avenue address."[2]

The Tax Reform Act of 1969 attacked this situation on several fronts. The primary tools Congress chose to control abuse were to institute a requirement that (roughly speaking) foundations must distribute an amount equal to five percent of their assets each year in pursuit of their charitable purposes,[3] and that foundations were barred from engaging in

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[1] Of course, even the term "private foundation" did not become a term of art until it was defined by the addition of section 509 to the Internal Revenue Code, which was accomplished by the Tax Reform Act of 1969. (Pub. L. No. 91-172, § , 83 Stat. 487, 496-98.) However, the term was in general use before then, primarily to describe an organization whose primary function was to make grants for charitable purposes.
[2] This is one of my favorite self-quotes, so I'm pleased to have another occasion to use it. See Richard Schmalbeck, "Reconsidering Private Foundation Investment Limitations," 58 Tax L. Rev. 59, 60 (2004).
[3] Originally, distribution of the greater of actual investment income or six percent of the foundation assets was required under section 4942(e). This was modified, eventually, to a flat five percent distribution requirement by the Economic Recovery Tax Act of 1981.

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virtually any transactions—sales, purchases, loans, facilities usage, etc.—with their "disqualified persons," a category that included donors, their family members, and business organizations that they controlled. These two rules—contained in sections 4942 and 4941, respectively, of the Internal Revenue Code ("IRC"), have been the subject of the preceding two papers at this conference. Those two rules can be fairly regarded as among the most important and successful tax reform efforts ever to affect nonprofit organizations in the United States.

But Congress did not stop there. It also added four other excise taxes to the array thereafter facing private foundations. IRC section 4940 imposes a tax on the investment income earned by a foundation. Section 4943 imposes a tax on "excess business holdings," which are defined in such a way that anything very close to a controlling interest in any form of business enterprise is effectively proscribed. Section 4944 imposes a tax on "jeopardy investments," which are defined as those investments that are so risky that they might "jeopardize the carrying out of any of [the foundation's] exempt purposes". And section 4945 imposes a tax on five categories of expenditures deemed by Congress to be taxable, including expenditures for lobbying, campaign activity, and grants to individuals or organizations other than public charities (unless the foundation engages in "expenditure responsibility" with respect to such grants).

These four taxes are not where the primary action is or was with respect to private foundations, and they have accordingly received relatively little analysis or commentary over the fifty years since their enactment.[4] They are, however, the subject of this paper. I will try to infuse them with as much excitement as I can manage. They are generally free-

[4] There has been some commentary, which I found helpful. However, in most cases, only relatively short sections of the following articles were devoted to the four excise taxes under discussion here. *See* John R. Labovitz, The Impact of the Private Foundations Provisions of the Tax Reform Act of 1969: early Empirical Measurements, 3 J. of Legal Studies 63, 82-85 (taxable expenditures), and 94-98 (excess business holdings) (1974); John G. Simon, Regulation of American Foundations: Looking Backward at the Tax Reform Act of 1969, 6 Voluntas: International Journal of Voluntary and Nonprofit Organizations, 243, 250 (tax on investment income) (1995); Homer C. Wadsworth, Private Foundations and the Tax Reform Act of 1969, 39 Law and Contemp. Prob. 255, 259-260 (tax on investment income) 260-61 (taxable expenditures) (1975); K. Martin Worthy, Consequences for Private Foundations of the Tax Reform Act of 1969, 39 Law and Contemp. Prob. 232, 242-44 (excess business holdings), 245-46 (taxable expenditures), 247-48 (tax on investment income) (1975).

standing, and have little to do with each other. So, for lack of any better organizing principle, I will consider them in the order in which they appear in the IRC. Because the case law, and even the various announcements and rulings of the Internal Revenue Service ("IRS") are scanty, I will rely heavily on the official legislative history, as embodied in the various committee reports, but also on the more substantial study done by the Treasury Department in 1965, which provided the genesis of most of the proposals eventually enacted by Congress in the Tax Reform Act of 1969, and serves as something of an unofficial legislative history of these provisions.[5]

[Read by youngest child present] "How is this excise tax different from all other excise taxes?"

Anyone who has recently taken an American Airlines flight without bringing enough to read knows that its in-flight magazine contains each month a "Mensa" quiz. A featured item type is usually in the general form of "which of these four is unlike the others?" With a little imagination, it is usually possible to come up with some characteristic that distinguishes each of the four, which is why this item type is in disrepute among psychometricians.[6] But let's play this game here.

The Tax on Net Investment Income (Section 4940)

So how is the excise tax imposed by section 4940 unlike the other foundation excise taxes? Easy. It is the only one that is actually designed to raise revenue—the only one, really, that deserves to be described as a tax. The others are actually penalty provisions disguised as taxes. But section 4940 appears to have been motivated by some combination

[5] Treasury Report on Private Foundations, transmitted to the Committee on Ways and Means of the U.S. House of Representatives on February 2, 1965.

[6] For example, if the list is dog, cow, horse, and cat, then the dog is the one that barks, the cow is the one with the four-part ruminant stomach, the horse is the one spelled with five letters, and the cat is the one that uses its claws for defense. Admittedly, in a well-designed question of this form, some of the distinctions are more compelling than others.

of a desire for revenue to be used in policing the private foundation sector, and a sense that private foundations collectively owned a sizable body of income-producing assets that ought not be entirely off the rolls of the income tax.[7] Briefly, it imposes an excise tax at a rate of two percent on the net investment income of foundations, with a proviso that the rate can be reduced to just one percent if the foundation meets certain requirements related to increasing its payout for charitable purposes.[8]

Although originally proposed in the House bill as a 7-1/2 percent tax,[9] the Senate cut back the rate to four percent, a change that survived the conference on the bill that became the Tax Reform Act of 1969.[10] In 1978, Congress further reduced the rate to just two percent.[11] And, in 1984, Congress provided the mechanism whereby a foundation could reduce the rate applying to its investment income to just one percent, as most foundations now appear to do.[12]

Even at the reduced rates, this excise tax produces significant revenue. In 2015 (the most recent year for which these data are available), the tax produced over $665 million, on a revenue base (net investment income) of nearly $49 billion, for an average tax rate of 1.36%.[13] Most of this tax—about $421 million--was paid by foundations having net assets exceeding $100 million, even though such foundations number fewer than 1000 of the roughly 100,000 foundations that file Form 990 PF each year.[14]

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[7] The report from the Ways and Means Committee indicated that "since the benefits of government are available to all, the costs should be borne, as least to some extent, by all of those able to pay." Rep. of H.R. Comm. On Ways and Means to Accompany H.R. 13270, H.R. Rep. No. 91-413, at 19 (1969).
[8] IRC § 4940(e).
[9] H.R. Rep. No. 91-782, at 13 (1969).
[10] S. Rep. No. 95-790, at 1 (1969).
[11] Revenue Act of 1978, §520 (1978).
[12] Tax Reform Act of 1984, Pub.L 98-369, Section 303. Section 4940(e) in general allows reduction in rate to one percent if the amount of the qualifying distributions during the taxable year is at least equal to the sum of the foundation assets times its average payout percentage over the preceding five years, plus one percent of the net income for the taxable year. In effect, this provision means that foundations must, to qualify for the one percent rate, slightly increase their payout percentage each year.
[13] Statistics of Income—Domestic Private Foundations and Charitable Trust Statistics, irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust statistics, last visited Sept. 24, 2019. (Hereinafter SOI Tax Stats.)
[14] Id.

This is also the only provision that was *not* among those originally proposed by the Treasury Department. Accordingly, there is no Treasury Report to rely upon in explaining this provision. However, when the Senate considered the legislation creating this tax in 1969, it was assisted by an unusual report prepared by the Joint Committee on Taxation, together with the Finance Committee staff.[15] The report explained the provisions of the House bill, and examined the arguments for and against each provision of that bill. These arguments assist in understanding Congressional thinking at the time, but to some extent also remain the major arguments for and against this tax. There were four arguments in favor of the tax:

"(1) Since private foundations enjoy the benefits of Government as do other entities and individuals, they should bear some portion of the costs of government, just as do other organizations and individuals."[16]

Well, yes. But not other exempt organizations, which have been given a free ride since the inception of the income tax. There is nothing in this statement of the argument that even tries to explain why foundations deserve less favorable treatment.

The report goes on:

"(2) The administrative machinery necessary to insure that private foundations currently distribute their funds for proper charitable purposes is becoming more and more costly. This tax will defray a portion of that cost. It is a modest levy which will not hamper the operation of private foundations."[17]

This is more like it, offering at least some basis for singling out private foundations for special assessments. Namely, the rascals are harder to police, so we'll have to spend more doing that. And they are the entities that should have to pay for that. Fair enough. But there's more.

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[15] Staffs of J. Comm. On Internal Revenue Taxation and Comm. on Finance, 91st Cong., Summary of H.R. 13270, The Tax Reform Act of 1969 (Comm. Print 1969). All the quotations in this section of the text are taken from this report.
[16] Id., at 11.
[17] Id.

"(3) Such a tax should encourage greater reliance upon the public than upon the one-time beneficence of one individual or family."[18]

This somewhat obcure statement can only be understood as reflecting a desire to discourage creation and funding of private foundations, in favor of contributions to public charities. But no reason is offered for that. I would imagine that it may simply reflect the pre-TRA69 state of the foundation world, which was full of abuses?[19] But if successful reform were possible, as we now know that it more or less has been, would this animus remain?

Finally, the report wraps up the side favoring the imposition of the tax with this argument:

"(4) Investment income of most other charitable organizations is not subject to tax [with a few exceptions noted] and it is unfair to single out foundations for this special tax."[20]

Whoops! It seems that those preparing this report inadvertently began the "con" side of this argument within the section that was supposed to contain the arguments favoring the tax.

So let's proceed to that side of the debate. The arguments against imposition of the tax, in addition to the one inadvertently placed in the "pro" side, began with this:

"(1) Since the advent of our taxing statutes, the Government has recognized the special place that private foundations occupy in our society and has granted them tax-exempt status. This tax is an incursion into that philosophy and seriously undermines it."[21]

But one must question the degree to which Government had recognized private foundations at all prior to 1969. There was no legal definition of the concept until IRC section 509 was added in 1969 to provide one. It would seem more accurate to say that Congress had paid little attention to foundations before 1969, and had simply not bothered

[18] Id.
[19] One might call it the wild west, but with a Park Avenue address.
[20] Joint Committee and Finance Committee Report, *surpa* note 15, at 11.
[21] Id.

to distinguish them in any way from other types of organizations that were organized and operated exclusively for charitable purposes.

The next argument in opposition to the tax was:

"(2) This tax will fall heavily upon those private foundations who [sic] have a profitable investment portfolio, and would reduce the fund that would be available for charitable purposes."[22]

This is self-evidently what taxes do; that which the government commandeers is unavailable for charitable distribution. But this argument doesn't really address whether that would be justified.

Finally, the arguments against enactment of the tax close with:

"(3) The foundation that secures more current income for current charitable benefits will be liable for a greater tax than a foundation which does the minimum the bill requires, and so the bill discourages good foundation management."[23]

This seems more than a little muddled. Obviously, it is true that the incentive to maximize investment return is muted by the fact that the foundation could retain only 92-1/2 percent (under the House bill being discussed) of the fruits of successful investment, rather than 100%. Again, that's what income taxes do; they always produce some discouragement of effort as the collateral damage of collecting a tax. But what did the staff mean when it mentioned a foundation that secures more income for *current* charitable benefits? If a foundation spent all of its investment income in pursuit of charity, rather than retaining it, the foundation should, *ceteris paribus,* have less investment income in the following year than a foundation that made a practice of retaining its investment income, as was generally possible prior to 1969.

We know the result: The Senate, after considering these arguments, appears to have been about half-convinced. They roughly halved the rate proposed by the House, and

[22] Id.
[23] Id., at 12.

passed the bill. As noted, they halved the rate again in 1978, and still another time (more or less) in 1984. However, those actions appear from the legislative history to have been based more on Congress' surprise at the revenue-generating potency of the tax, rather than being persuaded, to a greater or lesser degree, by the pro and con arguments considered in 1969.[24]

What can one make of these arguments today? First, the argument that private foundations impose greater administrative costs on the government would seem to be a powerful argument in favor of retaining the tax. *But only if that premise is well-founded, and only if the tax collected is commensurate to the greater administrative costs, and actually used for that purpose.*

Consider each of these three concerns. Is the administrative burden associated with private foundations greater than it is with other types of exempt organizations? This is a question better answered by tax officials and others who have experience with audits of private foundations, but I have doubts. For one thing, because foundations operate as financial intermediaries, their operations are in many respects simpler than those of a comparably-sized public charity.[25] The primary professional employees are grant officers, and perhaps a few investment managers. They need offices, desks, computers, and the usual stenographic and IT support, but not a great deal more. They don't need classrooms, laboratories, libraries, physical inventories, trucks, printing presses, kitchens, dormitories,

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[24] *See* Staff of Joint Comm. on Taxation, 95th Cong., General Explanation of the Revenue Act of 1978, at 295 (J. Comm. Print 1979). "The 4-percent excise tax on investment income of private foundations was enacted 9 years ago. This tax has produced more than twice the revenue needed to finance the operations of the Internal Revenue Service with respect to tax-exempt organizations. Because of the operation of the private foundation charitable distribution provisions, (sec. 4942(d)), this tax reduces the minimum amount that private foundations are required to spend or grant for charitable purposes. In many cases, the tax actually has reduced charitable expenditures. This experience with the tax and its impact on charitable expenditures has led Congress to conclude that it is appropriate to cut the tax rate in half."
Similarly, in 1983, the Ways and Means report indicated: "Thus, section 4940 excise tax collections continue to exceed the costs of administering not only the exempt organization program, but also the employee plan and exempt organization programs combined. . . . In light of these considerations the committee believes that the rate of the section 4940 excise tax should be reduced from two percent to one percent, but only where there is an equivalent increase in the foundation's qualifying distributions for charitable purposes. H.R. Rep. No. 98-432, at 167 (1983).

[25] I am speaking here about grant-making foundations, which constitute about ninety percent of all foundations. Obviously, operating foundations raise many of the same operational issues as a public charity would.

or any of the other infrastructure that might be needed by a charity that has a teaching, research, or social service mission. The actual charitable work, which may require more complex IRS review, is being done by their grantees, not by the foundation, whose budget and financial statements may be very clean by comparison to their grantees'.

There is of course a need to verify grant disbursements, but this doesn't seem likely to involve much difficulty. More difficulty, presumably, would be involved in screening for potential acts of self-dealing. But, absent outright fraud, even these should leave a paper trail that can be audited. At its worst, a private foundation audit might need to explore transactions with entities whose ownership is not obvious from the name on a record of the transaction. If land, for example, is sold to XYZ Partners, an auditor will need to find out more about XYZ partners, in order to be sure that no disqualified person is involved.

Verifying that the mandatory distribution requirement of section 4942 has been complied with would seem fairly routine, and could be based simply on the books and records of the foundation, again perhaps with spot checking to assure that disbursements were actually made, and were made to public charities, or were made in compliance with expenditure responsibility requirements.

Overall, then, it is not clear that private foundations actually require greater compliance efforts than public charities do. This is a very tentative conclusion, based on almost no actual experience with such audits. I presume those commenting on this paper will have a good deal to work with as to this point, and I would welcome their comments. I hope they will be kind.

As to whether the revenue raised is commensurate with any additional enforcement costs associated with foundations, the answer would seem to be that it clearly is not. When the House proposed a 7-1/2 percent tax in 1969, it estimated the revenue produced to be $65 million in the first year, rising to $100 million in the tenth.[26] This proved to be a gross underestimate, since even the four-percent tax actually enacted was quickly producing more than twice the revenue needed to oversee nonprofit organization early as the eighth post-

[26] Ways and Means Report, *surpa*, note 9, at 20.

enactment year.[27] One can understand some of the difficulties in making such as estimate, given that there was no separate private foundation concept prior to 1969, and so no easy way to estimate what the collective asset base of foundations was, without which it would be difficult to know how much investment income could reasonably be generated. But we know now how much is generated, and the sums seem completely incommensurate with any incremental administrative burden that foundations impose on the Internal Revenue Service. The entire enforcement budget of the IRS in 2015—the most recent year for which we have section 4940 data—was in the vicinity of $4.8 billion. This was for enforcement activities relating to about 140 million individual taxpayers, about 33 million business entities, about 200,000 public charities, and 100,000 private foundations. I have found no breakdown of the enforcement budget by the type of taxpayer, but these numbers make it hugely implausible to think that private foundations generated 15% of the IRS enforcement effort, even though the section 4940 excise tax did produce revenue equal to that percentage of the total enforcement budget.

The likely answer to the third question--did the IRS actually devote resources to enforcement activities directed at private foundations that were roughly equal to the revenue generated by the section 4940 tax?—seems to be clearly not, in light of the analysis immediately preceding.

So if the justification for the tax rests primarily on the argument that foundations should pay for the increment in IRS enforcement efforts that they have produced, the appropriate response would be that that incremental cost should be evaluated, and in the likely event that it could be covered with a vastly reduced tax rate, the rate should indeed be reduced to that level.

But what about the more general argument that foundations, like all other individuals and entities in the U.S., receive benefits from the government. And since they have a clear ability to pay tax to support that government, they should be obligated to do so. This is of course at odds with the notion that charitable organizations make their contributions to

[27] Joint Committee Report on Revenue Act of 1978, *supra* note 24.

American society in ways other than paying taxes, and that when and if they (occasionally) have an excess of operating revenues over operating expenses, they should be exempt from tax on those excesses—which, after all, continue to be held for charitable purposes, rather than for distribution to stockholders, employees or others.

One could imagine this excise tax being justified by two distinct arguments—both rather bold--about the relationship of charitable entities to the fisc. Both are really beyond the scope of this paper, but it won't hurt to raise them, for whatever thoughts they might provoke.

The first is that charities—perhaps not only private foundations--should be taxed not merely on their unrelated business income, but also on their unrelated investment income, for reasons similar to those that justify the unrelated business income tax. Investment income has always been exempt from the latter tax, but it is not entirely clear why that should be so. Investment income is related to charitable purpose only in the sense that it is ultimately used for such purposes. But that has not been enough to persuade Congress to exempt unrelated business income, which is also so used. The view that all unrelated income—that is, anything that doesn't come from program service revenue—should be taxed would primarily affect two types of institutions: foundations and universities. Collectively, such institutions have a great deal of wealth, and it is worth considering whether the income generated by that wealth should be wholly immune to taxation. But this is a big question, and we're dealing here with four little excise taxes. So perhaps at some future NYU conference . . . .

The other argument is closer to the range of this paper. Even if we don't want to tax income from endowments generally, perhaps it is acceptable to impose a modest tax on foundations, as a reflection of their disfavored status in the hierarchy of charitable organizations. It is clear that Congress *has* disfavored foundations in a number of ways. The other five excise taxes in the 4900 series effectively impose limits on the way foundations conduct their business that are not applied to public charities. And contributions to private foundations are subject to several limitations on deductibility that

do not apply to public charities. The section 4940 excise tax, it could be argued, is part of the deal.

There is no definitive answer to this argument. But it should be noted that most of the ways that private foundations are disfavored are designed primarily to control perceived abuses. To the degree those measures are effective, we would expect to have a private foundation world that is reasonably free of abuse—as free of abuse, in any case, as any public charity. If that is so, then the only reason for further disfavoring foundations is that they tend to defer expenditure for direct charitable benefits. The other side of that coin, however, is that they also tend to preserve funds for the provision of charitable benefits in the future. The question then comes down to one of generational equity. And at that point, we are again well beyond the scope of this paper.

In the end, then, the justification of the section 4940 excise tax seems shaky indeed. If tied to the special costs of enforcement relating to foundations, its rate should be drastically reduced, and the revenue derived from it should actually be devoted to that purpose. And unless one is ready to argue for taxation of all endowment income, or to argue that our society should generally prefer to provide charitable benefits to lives in being rather than future generations, there is no compelling alternative justification for this tax.

Excess Business Holdings Rules (Section 4943)

That concluding observation was designed in part to set up the question of how the excess business holding tax is different from the other miscellaneous foundation excise taxes. While this is controversial, it is my view that the excess business holdings tax has no appropriate purpose, and in some cases pointlessly impedes the flow of altruistic funds to charitable ends. It is different, then, in that it is affirmatively damaging overall.

Though section 4943 is a complicated provision,[28] a brief descritption of the tax will suffice for present purposes. The excess business holdings rules contained in IRC section

[28] In the RIA Tax Reporter, the Code provisions take up more than six pages, and the regulations consume more than 46 pages of paper that could have been devoted to some other subject.

4943 impose an excise tax on any foundation that owns interests in a corporation if those holdings exceed 20% of that corporation's voting interests outstanding. Holdings in partnerships or other enterprise forms are also subject to these limits, which are similarly set at 20% of the "profits interest" in the business enterprise.[29] Although formally structured as a two-tiered excise tax of 10% and 200%, respectively, of the value of the excess holdings,[30] it is, as noted above, more appropriate to think of these provisions as an absolute prohibition on excess business holdings. The fact that a tax exceeding 200% of the tax base is doubly confiscatory in general means that it would never be rational to tolerate the tax rather than avoiding it.

In applying the 20% test, any interests held by persons who are "disqualified persons" with respect to the foundation are attributed to the foundation. Disqualified persons include substantial contributors and foundation managers, as well as their family members[31] and other entities in which they have interests exceeding 20%. There is a *de minimis* exception to this attribution rule: even if more than eighteen percent of the stock is owned by disqualified persons, the foundation is nevertheless permitted to own up to two percent of the stock of that enterprise.[32]

Recognizing that foundations might come to be owners of business interests that would exceed these limits by *inter vivos* or testamentary gifts, section 4943 allows foundations a five-year grace period within which to dispose of the interests that would constitute excess business holdings, without being exposed to the section 4943 excise taxes.[33]

These rules, as well as several others regulating private foundations, originated in the

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[29] See Treas. Regs. §53.4943-3(c)(2). Also, the 20% limit can be raised to 35% if the foundation can demonstrate that persons other than the foundation and its disqualified persons effectively control the corporation or other enterprise. IRC §4943(c)((2)(B).
[30] IRC §§4943(a)(1) and 4943(b), respectively. The second-tier tax is imposed only if the foundation fails to dispose of the excess holdings by the time the first-tier tax is proposed or assessed. IRC §4943(d)(2)
[31] IRC §(d) defines family members to include the individual's spouse, ancestors, and children, grandchildren, and great grandchildren, as well as spouses of children, grandchildren, and great grandchildren.
[32] IRC §4943(c)(2)(C).
[33] IRC §4943(c)(6). This period can be, and often is, extended under some circumstances. IRC §4943(c)(7).

Treasury Department, and were proposed in a report submitted to Congress in February of 1965 (the "Treasury Report" or the "Report"). While the usual committee reports exist, and constitute the official legislative history of the TRA '69,[34] those reports largely track (but often merely summarize) the Treasury Report, which provides a more comprehensive explanation of the provisions. This paper will accordingly rely largely on the Treasury Report for explanation of the purposes of the various proposals it offers.

The main substance of the Treasury Report is contained in "Part II," which identified six "problems" (in the Report's own terms) in which foundation performance could be improved. At the conclusion of each section detailing these "problems," the Report offered possible solutions. The first two of these—labeled "self-dealing" and "delay in benefit to charity" have been alluded to above. They were without doubt the centerpieces of the private foundation reforms, and were directly addressed by new rules prohibiting self-dealing, and mandating annual distribution of at least five percent of the foundation's assets.[35] The third and fourth problem areas were addressed by the excess business holdings rules, and will be detailed below. The fifth problem area had to do with specific investments that the Treasury deemed inappropriately speculative, which the Treasury suggested should be flatly prohibited; this will be discussed in the section immediately following this one.

Finally, the sixth proposal addressed the problem of indefinite control of the foundation by its creators or their descendants. The Report proposed that foundations be required to transition to independent directors by the time the foundation had existed for 25 years. It is critical to a proper understanding of Congressional views on business holdings of private foundations to note that Congress chose not to enact this recommendation, implicitly assuring the foundation world that indefinite control of a foundation by its disqualified persons was something that Congress could tolerate.

In this section of this paper, the focus will be on the third and fourth "problems" highlighted by the Treasury Report. The third "problem"of Part II of the Report was titled

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[34] See the Ways and Means Committee report, H.R. Rep. No. 91-413, at 218, reprinted in 1969-3 C.B. 200, 218, and the Finance Committee Report, S. Rep. No. 91-552, reprinted in 1969-3 C.B. 423, 449-450.

[35] IRC §§4941 and 4942, respectively.

"Foundation Involvement in Business." Here the Report cited many examples of foundations that at the time held controlling interests in businesses, typically medium and large corporate businesses.[36] The Report found these holdings problematic for several reasons.

First, it was thought that such businesses might compete on unfair terms with for-profit businesses. It should be noted that the unrelated business income tax, which Congress adopted in 1950, was greatly strengthened by other provisions of the TRA '69. In particular, the much narrower exemption for income from rental property put an end to the so-called "Clay Brown" transactions, which the Treasury thought were particularly abusive.[37] Aside from particular transactions of this type, the Report expressed the view that tax-exempt organizations enjoyed an advantage in accumulating capital—both initially (due to the deductibility of contributions), and as a continuing matter (due to their ability to re-invest all of their profits, rather than merely their after-tax profits).

These arguments, however, are not well-founded. The initial accumulation argument ignores the fact that when capital is invested in a for-profit corporation, the investor continues to own the economic value of that investment, albeit in a different form--capital stock rather than cash. In the case of a charitable contribution, the donor must permanently surrender the donated economic value. The deductibility of the contribution somewhat softens that blow, but it is nevertheless true that the contribution, even after accounting for its deductibility, leaves the donor with less wealth than she had before. It is surely easier to persuade a holder of capital to *invest* his funds in a promising enterprise than it is to persuade him to give them away.

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[36] Treasury Report, pp. 30-31. There was also a detailed Appendix that named the foundations whose situations had been studied by the Treasury Department. It is something of a "Who's Who" of foundations existing at the time, and includes data regarding the Mott, Kellogg, and Kresge Foundations, among several others. Treasury Report, Appendix 1, pp. 96-99.

[37] "Clay Brown" transactions were so named after the Supreme Court case that sustained the tax benefits that the taxpayers in that case claimed, over the strenuous objections of the government. Comm'r v. Brown, 380 U.S. 5632 (1965). The transactions involved sale-and-leaseback arrangements with for-profit businesses that were structured to produce deductions for the for-profit business, and (untaxed) income for the exempt party to the transaction. They are too complicated to describe fully here, but details can be found in the case itself, or in Schmalbeck, "Reconsidering Private Foundation Investment Limitations," 58 Tax Law Review 59, 73-76 (2004).

Nor is the re-investment of profits argument convincing. In the cases referenced in the Report, the businesses in question were large corporations, which would in virtually every case be subject to the corporate income tax, which must be paid whether the owners of the corporation are individuals or tax-exempt entities. If the owners of a corporation wish to finance internal growth, they can cause the corporation to retain its earnings for that purpose. In such a case, whether the corporation is owned by individuals or a foundation, there will be a corporate tax paid, but no other tax.

The Report went on to note possible self-dealing problems, and delays in delivery of benefits to charities. Those were appropriate concerns at the time the Report was written, but are effectively addressed by the self-dealing prohibition and mandatory distribution requirements imposed by the TRA '69.

Finally, the Report argued that foundation ownership of a substantial business may create a conflict of commitment, or what might be called a "distraction" problem; that is, the foundation managers may become more interested in operation of the business than they are in the operation of the foundation. It is not possible to refute this claim conclusively. But two arguments to the contrary should be considered.

First, the success of the foundation is to a considerable degree linked to the success of the enterprises in which the foundation's investment assets are placed. So an interest in the business enterprise is not necessarily in competition with an interest in the charitable endeavors it will support. Concern for the health of endowment assets and for the success of the charitable program can go hand-in-hand.

Second, most foundations of any size find it sensible to segregate their investment functions from their grant-making functions. The skills needed to manage the foundation's investment assets are quite unlike the skills needed to advance the charitable goals of the foundation through strategic grant-making. Very small foundations may not have the luxury of segregating functions in this way, but very small foundations are not a very important part of the foundation world. In 2015, the most recent year for which comprehensive data are available, foundations with assets of at least $10,000,000 held 87.0% of all foundation

assets; and foundations with assets of at least $100,000,000 held 62.2% of all foundation assets.[38] The private foundation world is dominated by large foundations, and in such foundations, the personnel handling grants have little or nothing to do with management of the foundation assets.

Following its description of its concerns, the Report offered a solution: limit private foundations to ownership that does not exceed 20% of the voting stock (or other controlling interests, in the case of non-corporate businesses) of any business enterprise.[39] Interestingly, the Report considered whether interests held by donors and other insiders should be attributed to the foundation, and *explicitly advised that they should not be*.[40]

The fourth problem considered by the Report was related to the third, but viewed from a different vantage point. Both involve foundation control of a business, but the fourth concern looked not primarily at involvement in the business, but rather at the use of foundations to maintain control of a family enterprise.[41] In describing this concern, the Report once again led with the two central policy considerations that animate the entire report; self-dealing and delay in distribution of benefits to charity. The authors of the Report worried, for example, that foundation managers might be tempted to have the corporation employ family members; and that the corporation might not pay out enough in dividends to allow any significant distributions for charitable purposes.[42]

These concerns are not ultimately convincing. In the employment case, it should be noted that the foundation itself can permissibly employ family members. Perhaps availability of the position roster of the corporation expands the range of this power, but how many relatives are typically involved in these cases? Note also that if the foundation ownership is limited to 20% (as the Treasury proposed), it will be the shareholders who

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[38] Author calculations based on IRS Data Report on Private Foundations, 2015, at https://www.irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics#2
[39] Treasury Report, at 36.
[40] "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 the donors, officers, directors, trustees, or employees for their own benefit should not." Id.
[41] Treasury Report, at 37-44.
[42] Treasury Report, at 40.

control the other 80% who would control employment and other decisions made by the business enterprise. As for setting dividend policy, the mandatory distribution rules proposed by the Report, and adopted by Congress in TRA '69, would mean that the foundation would need either to have substantial dividend income if its assets consist primarily of corporate stock, or it will need to sell the stock to raise the cash necessary to meet the five-percent distribution requirement. If the object of making a gift of stock to the foundation was to maintain the stockholdings in private hands, it would make no sense for the shareholders to cause the corporation to retain earnings to a degree that sale of that stock to outsiders by the foundation becomes necessary. Once again, it can be seen that concerns in the excess business holdings area are greatly attenuated by the reforms enacted elsewhere in the TRA '69.

Following the description of concerns, the Report offered its suggestion: that the deduction for any contribution of stock exceeding a 20% interest be deferred until the excess above that level was disposed of. In general, there would be a three-year period within which a disposition might occur, after which the deduction would simply be forfeited. Interestingly, in contrast to the decision regarding attribution expressed in the third section of the Report, in this section, the Report did recommend that stock owned by the foundation's disqualified persons be attributed to the foundation.

As the several proposals made their way through the Congressional processes, the recommendation to defer the charitable deduction was dropped. However, the rule that would attribute stock owned by a foundation's disqualified persons was appended to the 20% limit on stock ownership that was proposed in the previous section. The committee reports contain no discussion of the reasoning behind that conflation of the proposals in the third and fourth section of Part II of the Report, presumably because they were added after the bill was reported to the floor.

And, again, it is important to note that Congress did <u>not</u> enact the Treasury proposal that control of a foundation be transferred to independent parties (that is, persons other than the foundation's disqualified persons). Congress appears to have had much less concern than the Treasury on the question of retention of control of a corporation by

members of the family that historically controlled it.

For convenience, arguments countering the explanations and rationale offered by the Treasury Report were expressed above, immediately following those explanations and rationale. However, a few additional, broader arguments should be considered.

Foundations are often funded by large testamentary gifts. So in an important sense, the excess business holdings rules implicate the goals of the federal estate tax. Some critics find it objectionable that wealthy families may be able to use a private foundation to maintain family control of a family business enterprise, even while shielding some part of the family's wealth—more precisely, a *former* part of the family's wealth, since it no longer belongs to them once transferred to the foundation--from the estate tax. If a family can retain control of an enterprise, it is argued, it ought not be eligible for tax deductions.[43]

The purpose of the estate tax, which was enacted in 1916, was not clearly explained at the time—committee reports did not generally contain explicit rationales for proposed legislation until much later. In fact, the context suggests that raising revenue to finance the U.S. entry into World War I had a good deal to do with the initiation of this tax. However, commentators have over the years since offered many justifications of the estate tax, and these can be distilled to just a few: the tax raises some revenue (and could raise much more if Congress wished); the tax operates to diminish economic inequality; and the tax somewhat discourages the creation and maintenance of dynastic wealth.[44]

Reducing somewhat the economic power that can be passed from one generation to the next is clearly among the purposes, then. However, that power is normally reduced to simple, quantitative terms. If one considers a 40% estate tax, which applies to all assets of a decedent in excess of a $20 million exemption, an estate of $100 million would yield a tax of $32 million—40% of the $80 million that remains after application of the

[43] This argument was recently advanced by Professor Brian Galle of the Georgetown University Law Center in a blog post available at: https://medium.com/whatever-source-derived/newmans-own-says-tax-law-will-burn-them-but-their-arguments-lack-pop-3d759c63fd9d#.yelfxrk7b.
[44] See, e.g., Michael Graetz, To Praise the Estate Tax, Not to Bury It, 93 Yale L.J. 259 (1983)..

exemption.[45] If—as is usually the case—the executor needs to sell some assets in order to discharge the tax obligation, she is free to choose the particular assets to sell. If the surviving family members wish to maintain control of a family business enterprise, the executor will ordinarily try to avoid selling assets relating to that business. The law does not require, or even favor, disposition of the assets of a family business in order to reduce the family's power that that collection of assets represents. Taking a 32% net excise of the family's wealth before transmitting it to the next generation is all the reduction in economic power that the estate tax mandates in this case.

Indeed, whenever Congress has expressed its views on the effect of the estate tax on preservation of family businesses, it has indicated that it strongly prefers that the estate tax *not* lead to the forced disposition of such businesses. This preference is manifest in a number of provisions Congress has added to the IRC over the years. An example is the set of rules regarding deferral of the payment of estate taxes. IRC section 6166 allows payment of the tax to be deferred for five years, and allows payments following that for ten more years. IRC section 6601(j) allows a significant discount on the interest rate charged on the bulk of the tax deferred under section 6166, charging only 45% of the rate generally charged on underpayments of tax. When Congress expanded rules allowing deferral in 1997,[46] the House Budget Committee explained the justification for deferral as follows: "The Committee believes that the installment provisions need to be expanded in order to . . . prevent liquidation of [closely held] businesses in order to pay estate taxes. The Committee further believes that the protection of closely held businesses will preserve jobs and strengthen the communities in which such businesses are located."[47]

Finally, it should be noted that our tax laws have always allowed deductions for contributions to private foundations, a stance that was not fundamentally altered by the TRA '69. This is an acceptable outcome because donations to foundations do permanently

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[45] This is a stylized version of the estate tax currently in place. The exemption is fixed by statute at $10 million (though it is indexed for inflation after 2012), but a married couple can effectively combine their exemptions.

[46] Revenue Reconciliation Act of 1997, Pub. L. 105-34.

[47] Rpt. 105-148 of the House Committee on the Budget, reprinted in 1997-4, v. 1, C.B. 319, 678.

transfer wealth from private hands to charitable ends. It is true that: 1) foundation directors or trustees may be the same individuals (or their close relatives) who made the gifts funding the foundation; 2) that those directors/trustees will oversee the investment of the funds that the foundation holds; and 3) those directors/trustees will oversee the annual distribution for charitable purposes of five percent of the foundation's assets. There is, in other words, a good deal of control retained by an individual or family that creates and manages a private foundation. Indeed, one could say that that is the very point of creating a private foundation, rather than simply making a contribution to a public charity. But there is no reason to believe that Congress finds that level of control objectionable, or finds in that control a reason to deny or defer a charitable contribution deduction.

The Treasury Department had reasons to propose the excess business holdings rules in 1965, and Congress had reasons to enact them a few years later in TRA '69. However, the proposals were offered at a time when there were no effective proscriptions on self-dealing, and no requirement that foundations distribute any part of their assets for charitable purposes at any particular time. With the addition to the IRC of strong prohibitions on self-dealing, and rules requiring substantial annual distributions for charitable purposes, much of the need for additional, largely redundant rules relating to business holdings disappeared. The arguments favoring such rules, apart from the self-dealing and current distribution issues—are unconvincing. The primary effects of repealing those rules would be simply that individuals whose wealth was concentrated in ownership interests in a family business would be better able to fund a family foundation during their lives, and that foundations might be, in some cases, useful to a family in maintaining control of a family business.

The first of these outcomes is presumably something the law should favor, since the law does generally favor the transfer of wealth for charitable purposes. The second may be more controversial, but there is no compelling reason to prevent a family from retaining control of a family business. That has never been a purpose of the estate tax, and, indeed, Congress has taken several steps at various times to assure to the degree possible that the estate tax will not have such an effect.

Thus, the benefits of the excess business holdings rules are not merely modest; they

don't exist at all. Regardless of what the Treasury Department and Congress thought in the 1960s, these rules today appear primarily to have the effect of delaying the transfer for charitable purposes of business interests that their owners are willing altruistically to part with. The best solution to this problem is simple: section 4943 should be repealed.

There is, however, an alternative that may be palatable to Congress and the general public, as well as affected private foundations. Recall that in their original form, as described in the third section of Part II the Treasury Report, the excess business holdings rules would have applied a 20% control test *without* attribution of any interests held by the foundation's disqualified persons. This would retain the core of the current IRC section 4943, in that it would prevent a foundation from holding more than a minority interest in a business enterprise. And it should relieve the concern about such things as distraction from charitable purpose, because a minority shareholder, being unable to control corporate policy, would have little reason to invest much time or attention in considering policy alternatives.

It may be useful to consider two situations: one in which the balance of control (at least 30%, yielding true legal control of more than 50% when viewed together with the presumed 20% direct ownership by the foundation) is held by the foundation's disqualified persons, and one in which the balance of control is held by outsiders. In the first situation, involving a family-controlled corporation, foundation ownership at the 20% level would not place the foundation in the position of controlling the business. Rather, control would be held by the family members, much as it would have before transferring up to 20% control to the foundation.

In the case in which outsiders own more than 50% of the business, it is clear that the foundation would not be in a position to exercise control. In times past, it might have been possible, in cases where outside ownership was highly disparate, for a foundation to control a corporation with as little as 20% ownership—though it is worth noting that even in 1965, the Treasury was comfortable using a 20% yardstick as the appropriate measure of control. Minority control with only 20% ownership is even less likely today, with the advent of private equity firms, leveraged buy-outs, and similar means of converting ownership of businesses. Even highly disparate owners of businesses can respond to tender offers, and will

do so if a business is being badly managed by a group with practical control, but not legal control at the 50% level.

The advantage of a 20% limit without attribution is that a foundation whose disqualified persons own substantial amounts of stock would find that, instead of being limited to the mere two percent ownership allowed by section 4943's *de minimis* rule, it would be allowed to own 20%, fully ten times as much stock of a family corporation as had been permitted before this change. This in turn would permit altruistically motivated family members to make contributions in the form of ownership interests in a family business, which in many cases would be the most convenient—sometimes the only—reasonable means of increasing the resources available for the charitable work of the foundation.

To be sure, either complete repeal or the intermediate position just described could enable a family to retain control of a family business for a longer period, due to foundation ownership of business interests that might otherwise be available to a broader market of outside owners. But that should be viewed as an advantage, since preserving family ownership of family businesses in the face of the estate tax has been expressed as an explicit Congressional goal.

There is another, quite different situation in which the excess business holdings rules have proven to be a major nuisance. Although less common than the situation in which both family members and the foundation own stock in a corporation, there have arisen in recent years situations in which the foundation has wanted to hold *all* the stock of a corporation, so as to control a corporation that will operate exclusively for the benefit of charitable enterprises, and will itself be operated in a manner consistent with the charitable goals of the foundation's benefactor(s). An example is "Newman's Own," a corporation that manufactures and markets a variety of consumer goods, mostly food items such as salad dressing, popcorn, spaghetti sauce, and the like. Because the excess business holdings rules have a five-year fuse, Newman's Own was able to operate for a few years under its original model. But in the longer term, the foundation would not have been able to hold all the stock of the corporation without violating the excess business holdings rules.

Some have argued that that would be just as well—that the foundation would be a poor steward of the corporate assets, and that better returns, all for the benefit of charity, of course, could be generated by selling all or most of the corporate stock, and investing it in a more diverse portfolio. Even if that were true, however, it ignores the fact that Newman's Own is pursuing at least one other aspect that was a high priority for the founder. It is expressed in their motto that "Quality will always trump the bottom line," a motto not frequently heard in the context of for-profit corporations.[48] While it could be argued that that is something of a noncharitable purpose, that does not appear to be a point that Congress wished to make, because in 2018, it added section 4943(g) expressly to grant an exception to the excess business holdings rules for this sort of organizational structure.[49]

This raises a more general point about foundation investment: May a foundation make an investment in a hybrid vehicle like a "benefit corporation"[50] or "low-profit limited liability company"?[51] Such enterprises are permitted to earn and distribute profits, but are also intended to serve other purposes, such as protection of the environment, advancement of the interests of their employees, and so on. Should such investments be regarded as program-related investments, which are also exempt from the excess business holdings rules? They might in some cases clearly qualify as such, though in others they might have difficulty. Though this is an interesting issue that is at the edge of the Newman's Own situation, it is not directly implicated, and is somewhat outside the scope of this article. For purposes of this article, I will assume that section 4943(g) puts the Newman's Own challenge to rest, which in my view is a useful reform.

In sum, Congress has dealt adequately with the Newman' Own situation, but has not addressed the situation in which both a foundation and members of its founding family with to hold stock in the same family business. The principal effect of the excess business holdings rules in such cases is simply to chill transfers to charity that might otherwise take

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[48] *Total Giving,* Newman's Own Foundation, jttps.//newmansownfoundation.org/about-us/total-giving (last visited 9/30/19.)
[49] Bipartisan Budget Act of 2018, Pub. L. No. 115-123, §41110, 132 Stat. 159 (2018).
[50] *See, e.g.,* N.Y. Bus. Corp. Law §1701 (2019) (enabling benefit corporations in the state of New York.)
[51] *See* 11 V.S.A. §4161 (2019) (enabling low-profit limited liability companies in the state of Vermont.)

place. It is difficult to see how that can be sound social and economic policy. So, among the miscellaneous foundation excise taxes considered in this paper, these are uniquely damaging. They deserve either outright repeal, or modification to remove the attribution rules so that foundation could own up to 20 percent of the stock of corporations even if their disqualified persons also own stock in that corporation.

Jeopardizing Investments (Section 4944)

Section 4944 is another penalty disguised as an excise tax, in this case one that effectively prohibits foundations from "invest[ing] any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes . . . ." The initial tax of 10 percent of the jeopardizing investment, imposed separately on the foundation itself and on the responsible foundation manager, is backed up by a second tier tax of 25 percent on the foundation, and 5 percent on the manager.

The section of the Treasury Report that deals with this subject begins with three examples, one of which describes "speculative securities dealings;"[52] another of which is primarily about a particular foundation's very active trading, leading to a turnover of about 20 percent of its holdings is a particular year;[53] and a third involves speculation in agricultural real property, in the anticipation of urban growth that failed to materialize.[54]

The Treasury Report saw three problems with such investment patterns. The first is the most obvious, and the one best captured by the language of the Code amendment actually enacted: that the investments were risky, and might endanger the ability to the foundation to discharge its charitable mission.[55] The second concern was that if the speculative investment was "spectacularly successful," it would make possible "both the financial empire building and the severance of a foundation from dependence on

[52] Treasury Report, at 52.
[53] Id.
[54] Id.
[55] Id., at 53.

contributors which [the report had previously identified as problematic]."[56] Finally, the Treasury worried that active trading would unduly distract foundation managers from pursuit of their charitable mission, resulting in its degradation.[57]

The first of these has some legitimacy in extreme cases, though the idea that a 20 percent turnover within a portfolio, or that strategic investments in real estate should be barred seems extreme. The second concern is just plain strange. What is wrong with "empire building" if the consequence is a much expanded pool from which financing for charitable activities could be made available? One imagines again that Treasury had too much in mind the pre-1969 foundation landscape, which one might call the wild west, but with a Park Avenue address. In those days, the empire was built largely so that it could be used as a family resource, or simply to be admired, without much thought given to the charitable work it could support. And the related concern about severing the foundation from dependence on contributors seems oblivious to the fact that many, perhaps most, foundations do not even seek contributions after they are funded by an initial, often testamentary, gift.

The third concern ignores the fact that the investment function can be, and probably should be, performed by personnel in the foundation other than those who are discharging the charitable functions. Grant officers have a professional background in the work of charitable organizations, but have no reason to be knowledgeable about the proper management of an investment portfolio. Others employees may have investment skills, but little knowledge about advancement of charitable missions. Those foundations that are too small to need or afford in-house investment advice have an array of "outside investment officer" options from which to choose.[58]

The Treasury report suggested a rule that would have included "specific interdiction of devices ordinarily deemed inherently speculative—as, for example, the purchase of "puts," "calls," "straddles," "spreads,"—the list goes on, but you get the idea. Short sales

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[56] Id.
[57] Id.
[58] For example, the Law School Admissions Council uses the Strategic Investment Group, an investment advisory firm, to manage its portfolio of roughly $200 million.

and commodities futures contracts would also have been barred, had the Treasury recommendations been followed.

What Congress did instead in section 4944 was quite general, effectively forbidding only investments that might jeopardize the foundation's ability to pursue its charitable mission. Congress thus left the details to the writers of the regulations, who duly followed in 1972 with somewhat more detailed guidance.[59] That guidance was offered largely in the form of examples. The first example describes three types of common stock investments, the first of which would be in a mature corporation with a good earnings record.[60] That would be ok. The second type was in a corporation that had a "promising product," but also a mixed record of gains and losses, and had never paid a dividend.[61] The third was a new corporation, with a new product that would need to compete with established firms offering alternative products that served the same purpose.[62]

The regulation concludes that the second and third types could be classified as jeopardizing investments, due to their risk elements.[63] One cannot help but note that this standard would have precluded investment in most of the great new companies of the last generation—Microsoft, Starbucks, Apple, Facebook, etc.—at least at the times when their stock was most attractively priced. It is also unclear from the regulations whether investment in index funds or other diversified mutual funds would have been permitted, if they included stock of new companies that hadn't yet established consistent earnings patterns.[64] The regulations are thus in serious need of amendment. There was even a reasonable opportunity to accomplish this, earlier in this decade, when the regulations

[59] T.D. 7240, 1973-1 C.B. 527.
[60] All three of the examples in the text are drawn from what the regulations label "Example (1). Regs.§ 53.4944-1(c), ex. 1.
[61] Id.
[62] Id.
[63] Id. It should be noted that "Example (2)" in this series of regulations offers means be which the defects of these two investments might be rectified, such as by an infusion of capital in the case of the second corporation, to "overcome the difficulties that have resulted in [the corporation's] uneven earnings record . . . ."
[64] To be fair, this may be because some of those investment vehicles, such as index funds, were not widely available when the regulations were written. There were certainly mutual funds, however.

relating to program-related investments (which are excepted from the general jeopardy investment rules) were extensively amended.[65] But such a project was not undertaken.

In addition to depriving foundations of several very profitable investment opportunities, the jeopardy investment rules potentially tread on ground that is more properly within the province of state regulation.[66] The common law of trusts had been the basis of a general imposition of a prudent investor standard imposed on foundation trustees,[67] but shortly after the Tax Reform Act of 1969, the Uniform Commissioners proposed the Uniform Management of Institutional Funds Act ("UMIFA"), which was eventually enacted in nearly all states.[68] And, showing in at least this one area a more contemporary sensibility than the IRS has shown, all states except Pennsylvania have now adopted the 2006 update to UMIFA, entitled the Uniform Prudent Management of Institutional Funds Act ("UPMIFA").

That act specifically provides that "an institution may invest in any kind of property or type of investment consistent with this section."[69] The consistency requirement basically entails prudence in evaluating investments, care in creating a balanced and diversified portfolio, and similar standards of ordinary care. It is clear that many investments types that the Treasury would have disapproved of in its 1965 report, and that the regulations under section 4944 make highly suspect, are now routinely employed in the portfolios of foundations and other nonprofit organizations. These include investments in hedge funds (which often involve short sales and option contracts), private equity firms (which often invest in fledgling businesses that are thought to have promise), and similar investments.

Foundations are able to do that because the saving grace of section 4944 is that the IRS appears to be paying very little attention to it. There are hardly any cases or rulings,

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[65] See. T.D. 9762, amending Regs. §53.4944-3.
[66] *See* James J. Fishman, "Stealth Preemption: The IRS's Corporate Governance Initiative",29 Va. Tax Rev. 101 (2010)
[67] See Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 77 Iowa L.Rev. 1151 (1992).a
[68] This model legislation was proposed in 1972, and won gradual enactment in 48 states. Fishman, Schwarz and Mayer, Nonprofit Organizations, at 189 (Fifth ed., 2015).
[69] UPMIFA, section 3(e)(3).

published or private, that invoke section 4944. One recent bit of published guidance, in Notice 2015-62,[70] addresses whether investments can be made that might generate less than highest rate of return, but which advance the charitable purposes of the foundation. One imagines that among the things the IRS had in mind are foundation portfolios that are designed to avoid investments in things like tobacco, alcohol, firearms, etc. The IRS may also have been thinking about investments in corporations that are certified B corporations or the like,[71] which pursue values other than profits, and are sometimes said to have multiple "bottom lines."

The Notice approves of such investments as long as the foundation exercises "ordinary business care and prudence."[72] Of particular interest is the statement toward the end of the notice that the standard employed in applying section 4944 is "consistent with the standards under state laws,"[73] specifically citing UPMIFA. The Notice does not address the fact that UPMIFA and the existing section 4944 regulations are in considerable conflict when discussing investments like hedge funds, which may employ puts, calls, short sales, and the like.

In general, it is obviously undesirable to have an apparently restrictive statute that does not in fact do much restricting because it isn't enforced according to its terms. Such a situation can create traps for those who read the regulations, and actually try to comply with them, not knowing that they really don't need to. In this case, however, that seems not to be a widespread problem. If foundation managers are even aware of section 4944, they seem also to be aware that it is treated as something of a precious antique, evoking amusement more than striking fear.

At least that is my impression. It is certainly possible that some small foundations—ones that cannot afford much professional guidance—might come across secondary references to section 4944, and derive from those the message that their foundation's

[70] Notice 2015-62, 2015-39 I.R.B.411.
[71] The idea of a B Corp is to further mission-driven parameters for measurement of performance of business entities.
[72] 2015 I.R.B. 411.
[73] Id.

investments should be conservative, by the standards existing in 1969. In such a case, however, that may be good advice. If those managers cannot figure out that the restrictions have been lifted, *de facto,* then perhaps they *should* confine the foundation to very simple, safe investments, since they probably lack the sophistication to do otherwise, and the resources to hire investment assistance.

So although section 4944 could damage optimal portfolio construction if taken seriously, it mostly isn't so taken. And it may have some limited utility in extreme cases. Truly negligent foundation managers may be impelled to better behavior more quickly by the potential use of section 4944 than by other, more deliberate enforcement means, because the excise tax can be imposed on both the foundation and the responsible manager. It may thus get the attention of the organization in a way that no threat to the organization alone could get. Although the case law reflecting actual use of section 4944 is scanty, it is imaginable that this excise tax is among the items mentioned in audits where its use might be appropriate, even if it ends up being unnecessary to actually assess the tax.

So, how is the jeopardizing investment tax under section 4944 different from the others? It is largely ignored, and that is just as well. If it were assiduously enforced, at least according to the terms of the existing regulations, it could have a deleterious effect on sound portfolio construction by foundation managers. If repealed, it would not be missed. Perhaps it serves as a useful stick that the IRS can muster in audits of seriously defective foundations, but in those cases it would never be the exclusive remedy.

Taxes on Taxable Expenditures (Section 4945)

The last of the miscellaneous excise taxes on private foundations is really a series of five taxes, lumped together under the somewhat redundant label of "taxes on taxable expenditures." This provision imposes at tax at a rate equal to 20 percent on the foundation, and 5 percent on the management, computed with respect to any of the dollar amounts of any of the following five expenditure types:

1) Expenditures for lobbying;

2) Expenditures for campaign participation;
3) Grants to individuals, unless the foundation complies with rules specified in section 4945(g), which requires "an objective and nondiscriminatory basis" for the grant.
4) Grants to other private foundations, with exceptions, including grants with respect to which the granting foundation exercises "expenditure responsibility," as defined in section 4945(h).
5) Expenditures for any purpose other than a charitable one, as defined in section 170(c)(2)(B).

As in the case of most of these excise taxes, the initial tax is backed up by a second-tier tax for uncorrected expenditures of 100% of the expenditure for the foundation, and 50% of the expenditure for the responsible manager.

It should be noted that the second and fifth of these expenditure types are expenditures that could lead to revocation of exempt status, being effectively barred by the language of section 501(c)(3) that defines eligibility for that status. And if a foundation were to have its exempt status revoked, the termination tax imposed by section 507 would seem to be available to the IRS. It is unclear what is added by the section 4945 taxable expenditure rules, which generally impose lower tax rates, in such cases. Perhaps they provide something of an intermediate sanction in situations where the IRS does not think that termination of exempt status is called for?

The other three expenditure types present disparate cases for regulation by prohibitive excise taxes, but all three do have reasonable justifications. Thus, the way in which section 4945 differs from the other three miscellaneous excise taxes is that it may actually be sensible—from its inception, and still today.

Consider first the lobbying provisions. Congress could have included foundations among the organizations that were subject to the section 4912 excise tax on "disqualifying lobbying expenditures," but it chose not to.[74] Similarly, the section 4911 tax on "excess

[74] Section 4912(c)(2)(C) specifically exempts private foundations.

expenditures to influence legislation" applies only to charities that elect the special lobbying rules of section 501(h)—an election that private foundations are barred from making.[75]

Congress wanted instead some special rules for lobbying by foundations. Those special rules, contained in section 4945(e), impose restrictions not applying to public charities. Foundations are, in brief, allowed to engage in lobbying in only three ways: they can provide "technical advice or assistance;" they can respond to written requests from legislators or other officials; and they may engage in so-called "self-defense lobbying," with respect to issues that "might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions . . ."[76]

Foundation executives seem quickly to have learned that the second of these exceptions is subject to some manipulation. Most foundations maintain relationships with Congressional representatives from their geographic areas, and can arrange to be invited to provide viewpoints whenever they want to. But that loophole has limits. It does not authorize widespread direct contact with the entirety of the membership of either house. Perhaps most importantly, it does not provide an exception to the flat prohibition on grass-roots lobbying in section 4945(e)(1).

Whether these restrictions are justified can certainly be debated, but they seem worthy of support to me. Any lobbying by charities is subject to the complaint that it provides a means of expressing views to Congress on a pre-tax basis. There is no deduction for lobbying expenditures incurred by individuals; and deduction for such expenditures by businesses is barred by section 162(e). But there is a deduction for contributions to charities, so if lobbying can be done by recipients of those donations, it puts donors in a uniquely favored position with respect to lobbying expenditures. This seems barely tolerable, but only if it is not abused. It is, after all, undoubtedly correct that many charities can advance their charitable missions by modest contributions to the public debate on issues that are among their concerns.

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[75] Section 501(h)(4) describes the types of charities that are allowed to make 501(h) elections, but foundations are not among them.
[76] Id.

Foundations may have specific charitable missions as well, of course, though they may be quite diffuse, and are generally pursued indirectly, through their grantees. But foundations are also often dominated by one or a few individuals whose political positions may be more their own than those dictated by their charitable missions. Lobbying by foundations thus comes unacceptably close to a general allowance of advancing an individual's political views on a pre-tax basis. The stiff tax (considering especially the second-tier tax) more than takes away any advantage an individual might perceive in using a foundation in this way. And so it should be.

The targets of the other two taxable expenditure rules are grants to individuals, or to other private foundations, but with a major exception applying in both cases: such grants may be made if the granting foundation exercises "expenditure responsibility" with respect to such grants.[77] Expenditure responsibility is defined in section 4945(h) as requiring "all reasonable efforts" and "adequate procedures"[78] to assure that the grant is "spent solely for the purpose for which made;[79] to obtain reports from the grantee about how the funds were spent;[80] and to make reports on those expenditures as part of their submissions to the IRS.[81]

There are separate regulations of some length relating to grants to individuals and to other private foundations.[82] These run to about eight or nine pages of fine print each in the RIA Tax Reporter version, and include numerous examples illustrating the basic concepts. One imagines that the need to be aware of the details within these regulations may well be intimidating, especially to smaller foundations that do not have the in-house expertise that would give them confidence that they would fully comply with these regulations.

The content of the regulations, however, seems entirely reasonable. And there are excellent secondary sources available that offer straightforward explanation of the concrete

[77] Section 4945(d)(3) and (4), respectively.
[78] Section 4945(h) (flush language).
[79] Section 4945(h)(1).
[80] Section 4945(h)(2).
[81] Section 4945(h)(3).
[82] Regs. §53.4945-4 and -5, respectively.

steps that a foundation should take to assure compliance.[83] One presumes, or at least hopes, that foundations routinely perform most of the steps required by the expenditure responsibility rules voluntarily, simply as a matter of best practice in grant-making. If anything, it might be argued that it would be better to expand the applicability of the expenditure responsibility rules than to contract them.

So, how do the section 4945 excise taxes differ from the others? They might actually be useful, and worthy of retention. They are the reason that one might not say that these miscellaneous excise taxes are good for absolutely nothing.

Conclusions

It is very difficult to draw overall conclusions from four such disparate sets of excise tax rules. It is more a question of identifying the good, the bad, and the ugly. And perhaps the irrelevant. Close readers of the preceding will have no problem knowing which are which, in the author's view. The good: the rules of section 4945, with its useful requirements directed at prudent grant-making, and its restrictions on lobbying by foundations. The bad: the rules of section 4940, imposing an excise tax on investment income that rests on shaky grounds for distinguishing such income received by foundations from that received by other charities, and a rate that in any case generates much more revenue than its rationale can support. The ugly: the rules of section 4943 that effectively prohibit foundations from holding significant positions in business enterprises in which their disqualified persons also hold significant positions. And the irrelevant: the rules of section 4944 regarding jeopardizing investments, which are fortunately ignored by the IRS, but which would hamstring foundation investment officers if enforced according to the terms of the existing regulations. If Congress were to revisit these four excise taxes, it should simply repeal sections 4943 and 4944, and at least extensively modify section 4940. Section

[83] See, *e.g.,*John Edie, Expenditure Responsibility: "It's Easier Than You Think," The Handbook on Private Foundations 248-253 (1919).

4945, on the other hand, could well be expanded in scope to all grants made by foundations, but perhaps in simplified form to ease compliance for small foundations.

Appendix: Revenue Generated by Private Foundation Excise Taxes

The IRS Statistics of Income section reports that foundations paid the following amounts of excise taxes in the 2017 tax year[84]:

Code section	Amount of Tax
Section 4940	$665,267,000[85]

[84] These are the actual dollar amounts, not expressed in thousands or millions, as is typical of Statistics of Income numbers.

[85] Unlike the other dollar numbers, this one is for the 2015 tax year, and is rounded to the nearest figure in thousands of dollars. It is not included in the separate table of excise taxes paid by charities that is found at

Section 4941	No report on this figure.
Section 4942	$8,364,790
Section 4943	$386,850
Section 4944	" **"[86]
Section 4945	$1,647,389

irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics, which is the source of the other data in this table.

[86] The IRS uses double asterisks in its statistical reports to explain numbers it has surpressed, explaining that "data [have been] combined to prevent disclosure of specific taxpayer data." But here there seems to be no data that have been combined. And in any case, this doesn't make a great deal of sense in the context of tax returns filed by charities, which are by law open to the public. Part VI, line 4a of the 990 PF requires (pointlessly, one would think) foundations to disclose whether they made jeopardizing investments in that tax year, and line 4b requires the same disclosure for prior years. Neither, however, requires disclosure of the amounts of those investments, nor the excise tax that might have been paid. Perhaps this tax was paid by only a single foundation? Perhaps it was paid by two foundations, which would permit each of those to infer the precise amount paid by the other? If there were at least three foundations that paid this tax, none of them could draw any definite inferences about the others.