Private Foundations and Spending Rules: Is Warehousing a Bad Thing?

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I. Introduction

One of the concerns that led to the Tax Reform Act of 1969 was the worry that wealthy donors could contribute wealth to private foundations and keep it there, getting the benefit of an immediate income tax deduction without a requirement that anything be used for charitable purposes or activities.[1] In addition, those concerned about the warehousing of assets in private foundations worried that the donors would continue to benefit from the assets held in their private foundations. This private benefit was at odds with the public interest in providing tax deductions in exchange for public charitable benefits.

The concern about warehousing led to enactment of Internal Revenue Code (IRC) section 4942, which imposes an excise tax unless a private foundation distributes a minimum amount each year. Thus, section 4942 effectively requires that a private foundation distribute the minimum amount. Related concerns led to enactment of restrictions on holding assets in a business in which the donor or the donor's family held interests and restrictions on investments that were too risky.

Fifty years after the enactment of the Tax Reform Act of 1969, concerns about warehousing persist. Critics argue, for example, that a donor should not be entitled to a deduction for the full value of a gift to a foundation given that charities and charitable activities may receive only a small amount[2] each year.[3] A review and discussion of the warehousing concern and the section 4942 requirement that private foundations distribute a minimum amount each year is timely. Three questions related to warehousing merit

[1] Private foundations are a form of endowment, so some legal rules and scholarly writing on endowments apply to private foundations and will be discussed in this paper. The paper uses the term "endowment" to refer to donor-restricted endowments broadly and uses the terms "foundation" or "private foundation" to refer to private foundations as defined for tax purposes. A gift to a private foundation will also qualify the donor for a deduction for either gift or estate tax purposes, depending on whether the gift is made during life or at death.

[2] A private foundation is required to distribute 5% of its investment assets each year. *See infra* Part II.B.2.a.

[3] *See* Brian Galle, *Pay It Forward: Law and the Problem of Restricted-Spending Philanthropy*, 93 WASH. U. L. REV. 1143 (2016) (advocating increased distributions); JOEL L. FLEISHMAN, PUTTING WEALTH TO WORK 15-17 (2017) (summarizing this critique). Although criticism of endowments surfaces periodically, Evelyn Brody describes the general support for perpetual endowments. Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 875 (1997).

attention: Is the spending rule of the section 4942 accomplishing the purposes behind it? How have changes in state law affected spending by private foundations? Do changes in donor interests and ideas about philanthropy suggest changes in the regulations?

This paper begins with the history of concerns over warehousing and the perceived need for a minimum distribution requirement. The paper then details the spending rule of section 4942 and considers how state law affects spending by private foundations. The article addresses several policy questions: What percentage is appropriate for the spending requirement? Should the percentage by higher, lower, or stay the same? Should private foundations be required to spend more quickly with the goal of not continuing in perpetuity? What are the advantages of perpetuity? Do the current rules discourage innovative philanthropy? And finally, what conclusions can be drawn with respect to the spending rule imposed on private foundations? What changes may be appropriate for the future?

Before turning to the discussion of the distribution requirement for private foundations, it is important to note that this paper focuses on private foundations and does not address the bigger question of whether a donor should consider creating a section 501(c)(4) social welfare organization instead. A social welfare organization can also be used for charitable grant-making, but the rules governing a 501(c)(4) organization are more flexible than those governing a private foundation.[4] The private foundation rules discussed in this paper do not apply to a 501(c)(4) organization, so a donor can avoid the distribution requirement altogether by using a social welfare organization rather than a private foundation.

A gift to a private foundation entitles the donor to an income tax deduction, while a gift to a social welfare organization exempt under section 501(c)(4) does not.[5] If the donor can use the income tax deduction, the private foundation may be the preferred vehicle, but some donors make such large charitable gifts that the income tax deduction

[4] *See* David S. Miller, *Social Welfare Organizations as Grantmakers*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 413 (2018). Miller provides a detailed examination of the benefits of using a social welfare organization as a charitable grant-making foundation.

[5] I.R.C. § 170(b).

cannot be used.[6] These donors, or donors for whom the flexibility of the 501(c)(4) organization is more important than the income tax deduction, may prefer to create a social welfare organization. Although the income tax deduction will not be available, the donor will have the income tax benefit of being able to transfer appreciated stock without an income tax consequence.[7] The donor will also have the benefit of a deduction from the gift tax.[8] Thus, it is useful to remember that a donor can choose to make charitable gifts through a social welfare organization and ignore the distribution rules discussed in this paper.

II. Federal and State Law that Affects Warehousing

A. Before 1969

As wealthy donors began to establish foundations in the early twentieth century, observers expressed concerns that this new type of philanthropy represented attempts to perpetuate wealth and influence.[9] Shortly after the creation of the Carnegie Corporation in 1911 and the Rockefeller Foundation in 1913, President William Howard Taft established the Walsh Commission on Industrial Relations to look into a number of issues, including concentrations of wealth in foundations.[10] The Commission's report criticized

[6] *See* Miller, supra note 4, at 414 (discussing Warren Buffett's gift to the Bill and Melinda Gates Foundation).

[7] *See id*. at 417.

[8] I.R.C. § 2501(a)(6). Any assets given to the organization will be removed from the donor's estate and not subject to estate tax when the donor dies.

[9] *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 67 (2004); Brody, *supra* note 3, at 876 (describing concerns based on fear of the power the accumulated wealth would give a dynastic family); William H. Byrnes IV, *The Private Foundation's Topsy Turvy Road in the American Political Process*, 4 HOUS. BUS. & TAX L.J. 496, 594 (2004); Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L. J. 1093, 1098-1131 (2001) (providing a history of foundations in the United States from the post-Revolutionary War period to the end of the twentieth century). Elaine Waterhouse Wilson, *Better Late than Never: Incorporating LLCs into Section 4943*, 48 AKRON L. REV. 485, 494-507 (2015).

[10] FREMONT-SMITH, *supra* note 9, at 68-69; Crimm, *supra* note 9, at 1103-04. Crimm cites two sources discussing private foundations formed before 1910. *Id.* at note 49 (citing Elizabeth T. Boris, *Creation and Growth: A Survey of Private Foundations*, in AMERICA'S WEALTHY AND THE FUTURE OF FOUNDATIONS 65, 70 (Teresa Odendahl ed., 1987) (indicating that there were 144 foundations in existence before 1910); JOHN W. NASON, FOUNDATION TRUSTEESHIP: SERVICE IN THE PUBLIC INTEREST 8 (1989) (indicating that there were

the foundations, accusing the founders of creating the foundations as a means to retain personal power.[11] The Commission recommended limits on accumulations, as well as other restrictions, but Congress did not act on the recommendations.[12]

By mid-century, concerns were heating up. Professor Nina Crimm describes the Congressional unease that had developed, based on data reported on foundation tax returns, as follows:

> By 1950, Congress was well aware that private foundations had been used for private gains, that they had engaged in income-producing activities unrelated to their charitable purposes, that some had accumulated large amounts of income and failed to distribute it, that foundations were being used as a tool to maintain control of family businesses and to protect funds from taxation, and that a judicial conflict existed over whether foundations' unrelated business activities were inconsistent with their tax-exemptions.[13]

Congress first attempted to address the accumulation of income by foundations in the Revenue Act of 1950.[14] Congress enacted section 3814 of the 1939 Code, and that section became section 504 of the 1954 Code.[15] Treasury had recommended a requirement that the foundation pay out its income within two and a half months following the close of its taxable year, with an exception for a reserve for contingencies and a limited ability to accumulate for a long-term commitment.[16] However, after both houses of Congress modified the bill, the enacted version permitted accumulations of

only sixty-two private foundations formed before 1910)). The Russell Sage Foundation, established in 1907 by Margaret Sage, has been described as the first modern era foundation. *See* PETER DOBKIN HALL, INVENTING THE NONPROFIT SECTOR 46-47 (1992) (cited by Crimm, *supra* note 9, at 1103). These new foundations—Sage, Carnegie, Rockefeller and others—were large, open-ended endowments devoted to broad goals. Rockefeller funded his with $100 million. Crimm, *supra* note 9, at 1103-04.

[11] FREMONT-SMITH, *supra* note 9, at 68-69; Crimm, *supra* note 9, at 1104-05; Waterhouse Wilson, *supra* note 9, at 494.

[12] FREMONT-SMITH, *supra* note 9, at 69; Crimm, *supra* note 9, at 1105 ("The report proposed restrictions on the size, functions, powers, and lives of foundations, and proposed limitations on the accumulation of unexpended income of private foundations. The report further suggested strict scrutiny of foundations' investments and open reports to government officials." Citations omitted).

[13] Crimm, *supra* note 9, at 1109.

[14] For an explanation of the development of the first restriction on accumulation of income, see Stuart Duhl, *Tax-Exempt Organizations: The Attack on Unreasonable Accumulations of Income,* 57 GEO. L. J. 483, 484-87 (1969).

[15] *Id*. at 486. Note that the current I.R.C. § 504 is used for a different purpose.

[16] *Id*. at 485.

income unless the amounts accumulated were "unreasonable in amount or duration…."[17] A violation of the new rule resulted in loss of exempt status for the year and for subsequent years until the organization distributed the unreasonable accumulations.[18] Neither section 3814 nor section 504 included a requirement that a foundation distribute its income or a percentage of its assets.

Although section 3814 (504) reflected an attempt to force more distributions, the vagueness of the rule prohibiting unreasonable accumulations of income made enforcement difficult, if not impossible.[19] In addition, foundations could avoid an accumulation of income by investing in a way that generated little income. Income was defined to exclude capital gains,[20] so a foundation could invest in assets that generated gain but no income. A foundation could also avoid income by investing in unproductive assets.[21] In either case, the foundation would have no accumulated income because it had no income as defined for purposes of section 504.

The problem with accumulations of income remained.[22] A charity dependent on donations from the public might need to demonstrate the ways it was using those donations, but a charity established by a single donor or a family would have no such constraints. The temptations to accumulate assets inside the private foundation were great, especially for a foundation holding the assets of a family business. Before Congress

[17] *Id.* at 486 (citing I.R.C. § 504(1)). The new section also required a foundation to publish information about its accumulations. The Senate Finance Committee thought the requirement would encourage foundations to increase distributions. *Internal Revenue Code Section 4942: Its Impact on Private Foundations,* 3 U. HAW. L. REV. 67, 71 (1981) (hereinafter "4942 Impact").

[18] Duhl, *supra,* note 14, at 487.

[19] *Id.* at 487-99. Duhl examines Revenue Rulings and cases interpreting this provision and concludes that "the criterion of 'reasonableness' is a totally inadequate standard in this area *both from the point of view of the taxpayer and the government.*" (Emphasis in the original.) *Id.* at 498.

[20] *Id.* at 487 (citing Treas. Reg. § 1.504-1(c) (1958), which defined income as "gains, profits, and income determined under the principles applicable in determining the earnings or profits of a corporation."). Duhl explains, "Accumulated income likewise does not include capital gains if the capital gains are reinvested, in good faith,
for the production of income within a reasonable time . . . ." *Id.*

[21] 4942 Impact, *supra* note 17, at 72.

[22] A 1962 survey indicated that only approximately one-fourth of all private foundations distributed an amount equal to their annual income. U.S. TREAS. DEP'T, 89TH CONG., 1ST SESS., REPORT ON PRIVATE FOUNDATIONS TO U.S. SENATE COMM. ON FINANCE 26 (Comm. Print 1965) [hereinafter cited as the 1965 Treasury Report]. *See also* Byrnes, *supra* note 9, at 587.

adopted restrictions on holding assets of a business,[23] a donor could transfer part or all of a closely held business to a charity and then use the charity's tax-exempt income to pay down debt held by the business or otherwise use the structure of the foundation to benefit the business.[24] The donor might transfer the voting shares to the foundation and retain control by controlling the foundation.[25] The family could retain nonvoting preferred stock and continue to enjoy financial benefits from the business.[26]

Criticism of foundations continued to grow,[27] and in 1961 Congressman Wright Patman, Chair of the House of Representatives Select Committee on Small Business, began a study of foundations that led to a multi-volume report presented to Congress over a ten-year period.[28] Patman was concerned with the accumulation of income in part because it occurred in foundations with foundation-controlled businesses.[29] Patman worried about competition with tax-paying businesses, competition he considered unfair, and he saw the use of private foundations as a way to avoid taxes through tax-free business transactions.[30] The reports identified abuses involving self-dealing and the use of foundations as tax shelters, and the reports recommended new regulations.[31]

During approximately the same period, the Treasury Department undertook its own study of foundations and in 1965 presented the report to Congress.[32] The report addressed criticisms of private foundations, including the contention "that the interposition of the foundation between the donor and active charitable pursuits entails undue delay in the transmission of the benefits which society should derive from charitable

[23] I.R.C. § 4945.

[24] *See* Waterhouse Wilson, *supra* note 9, at 488 (describing this scenario and citing the 1965 Treasury Report).

[25] *Id.*

[26] *Id.*

[27] The Cox Commission, established in 1952, investigated foundations to determine whether their resources were being used to promote Communism. In 1954 the Reece Committee examined foundations with a focus on their use by wealthy donors for tax avoidance and personal, social, or political power. *See* FREMONT-SMITH, *supra* note 9, at 69-72; Crimm, *supra* note 9, at 1110-12.

[28] FREMONT-SMITH, *supra* note 9, at 72-76; Crimm, *supra* note 9*,* at 1113-14; Waterhouse Wilson, *supra* note 9, at 495-500.

[29] Duhl, *supra,* note 14, at 501.

[30] *Id.*

[31] *Id*. *See also* FREMONT-SMITH, *supra* note 9, at 72; Crimm, *supra* note 9, at 1113-14; Waterhouse Wilson, *supra* note 9, at 495-500.

[32] FREMONT-SMITH, *supra* note 9, at 76-77; Crimm, *supra* note 9, at 1114.

contributions...."[33] The report recommended that this concern be addressed by requiring a non-operating foundation to distribute all of its net income, not including capital gains or contributions, on a current basis and by requiring the foundation to distribute a percentage of the value of the foundation's investment assets, if income fell below a reasonable rate of return on a diversified portfolio.[34] The report recommended granting the Secretary of Treasury the right to adjust the required percentage rate of distribution and indicated that for 1965 the appropriate rate would be between 3 and 3 ½ percent.[35]

The Patman reports and the Treasury Report amplified concerns that donors were creating private foundations and using them for private benefit.[36] Congress responded by adopting the Tax Reform Act of 1969 ("the 1969 Act") to curb the alleged abuses and attempt to ensure that a private foundation would be operated for public, and not private, benefit. The assumption behind the 1969 Act was that private foundations, operating without the oversight of the public, were susceptible to abuse in ways that public charities were not. Congress adopted new, bright-line rules governing private foundations to compensate for the lack of external oversight.

B. The Tax Reform Act of 1969

1. Tax Definition of Private Foundation

Although foundations existed long before the 1969 Act, the legislation established the category called "private foundation" and created a number of rules that apply to any

[33] Crimm, *supra* note 9, at 1116 (citing STAFF OF HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., TREAS. DEP'T REP. ON PRIVATE FOUNDATIONS (Comm. Print 1965) at 5). [hereinafter cited as the "Treasury Report"].

[34] *See* Duhl, *supra,* note 14, at 503 (citing Treasury Report at 26-29); *see also* 4942 Impact, *supra* note 17, at 78-79. (discussing Treasury Report).

[35] 4942 Impact, *supra* note 17, at 79 (citing Treasury Report at 28).

[36] For a discussion of the congressional hearings, see FREMONT-SMITH, *supra* note 9, at 77-79. For other articles discussing the reasons behind the 1969 Act see Brody, *supra* note 3, at 948; Crimm, *supra* note 9, at 1113-1123; Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59 (2004); Waterhouse Wilson, *supra* note 9.

organization considered a private foundation. Each of these "private foundation rules"[37] imposes an excise tax if a foundation engages in specified behavior. The effect is to require foundations to conform their operations to the rules, to avoid application of the excise taxes. A tax on investment income is the exception to this regime of behavior modification.[38] That small tax (currently 1-2 percent) applies to all private foundations.[39]

The 1969 Act divided charities into two categories for tax purposes: public charities and private foundations.[40] Each charity is presumed to be a private foundation unless it can meet one of the tests to be treated as a public charity: a traditional charity supported by the public or government, such as a church, school, or hospital;[41] an organization that receives more than one-third of its support from contributions, membership fees, and admission charges and less than one-third support from return on investment;[42] or a supporting organization.[43] The category of private foundation is further divided into grant-making foundations and private operating foundations. An operating foundation is one that carries out its exempt purpose directly.[44] A foundation that qualifies as an operating foundation is not required to meet the minimum distribution requirement of section 4942.[45]

The focus of this paper is on grant-making foundations, the foundations that carry out their exempt purposes by making grants to public charities or, in some circumstances, to other types of recipients. A grant-making foundation may also carry out some activities

[37] The rules created by the 1969 Act, in I.R.C. §§ 4940-4945, have become known as the private foundation rules. For a couple of early articles reflecting on the then-new rules, see Malcolm A. Moore, *Private Foundations - Their Present Tax Status*, 7 REAL PROP. PROB. & TR. J. 573, 584 (1972); Donald E. Vacin, *Guidelines for Foundation Administration under the Tax Reform Act*, 52 TAXES 277, 297 (1974) (reviewing the rules and record-keeping requirements).

[38] I.R.C. § 4940.

[39] *Id.* Congress included the tax on investment income to fund the cost of additional oversight necessitated by the new rules, but the revenue was never appropriated for that purpose. Crimm, *supra* note 9, at 1166. The original version of § 4940 imposed a 4 % tax. *Id.*

[40] I.R.C. § 509(a).

[41] I.R.C. § 509(a)(1).

[42] I.R.C. § 509(a)(2).

[43] I.R.C. § 509(a)(3). The supporting organization rules allow a foundation to qualify as a public charity through operational connections with one or more public charities. The rules are complicated and beyond the scope of this paper. *See* I.R.C. § 509(a)(3).

[44] I.R.C. § 4942(j)(3).

[45] I.R.C. § 4942(a)(1). *See* C. Wells Hall III, *Tax Planning for the Philanthropically Minded Business Owner*, 53 WM. & MARY TAX CONF. (2007), at 3-4, 11-13 (discussing rules for operating foundations).

directly, but not to the extent required to meet the operating foundation requirements. This paper addresses the issue of warehousing as it applies to grant-making private foundations and examines the private foundation rules with respect to this type of foundation.

2. Private Foundation Rules

a. Section 4942

The private foundation rules relate to the concerns that foundations should serve public and not private interests. The rule that most directly addresses the concerns about warehousing assets in private foundations appears in section 4942. This section imposes an excise tax if a specified amount is not distributed each year, and thus in effect requires the distribution of that amount.[46] This paper refers to this amount as the "required distribution amount," although the IRC does not use that term. The amount is a percentage of the value of the foundation's investment assets, rather than the amount of income earned that year. Section 4942 provides rules as to how the amount is calculated and which distributions count toward the total. Certain types of distributions not only do not count for purposes of section 4942 but may also cause the imposition of the tax imposed by section 4945 on "taxable expenditures."[47]

b. Sections 4940, 4941, 4943, 4944

The other private foundation rules are less directly connected to the concern about warehousing, although the rules could have affected amounts contributed to private

[46] I.R.C. § 4942(a). Malcolm Moore wrote about the private foundation rules shortly after enactment and described the distribution requirement as "[t]he greatest and most commonly encountered problem" in connection with the 1969 Act. Moore, *supra* note 37, at 576. The problem in the early years was that foundations did not understand total return investing and thought they had to make the required distributions from "income." *Id.*

[47] Distributions to foreign donees or individual donees may be taxable expenditures unless the foundation complies with additional requirements. *See infra* Part IV.D.2; Part IV.D.3.

foundations in the years immediately after enactment. The removal of opportunities for private benefit may also have resulted in less interest in warehousing assets rather than distributing them.

One set of allegations of abuse involved donors who obtained private benefit by engaging in transactions with their private foundations. Rather than requiring a determination of whether a donor or family member had taken unfair advantage of the foundation, section 4941 imposes an excise tax on acts of self-dealing, with some limited exceptions.[48] This section prohibits certain transactions between the foundation and the donor or other "disqualified person."[49] All charities must avoid conferring private benefit on an insider, but section 4941 uses a bright-line prohibition on transactions with insiders due to concerns about limited oversight for private foundations.

Many of the concerns raised by Congressman Patman's reports and the Treasury Report involved family businesses, so section 4943 restricts ownership of interests in businesses in which the donor or the donor's family hold significant interests. Section 4943 imposes an excise tax on "excess business holdings" and requires a foundation to divest itself of shares of a business owned in part by a disqualified person in order to avoid the tax. [50] Related, potentially, to business activities, section 4944 adds an excise tax on jeopardizing investments.[51] This section limits the types of investments a foundation can use and potentially limits the use of investments to carry out exempt activities. Section 4944 may not serve as much of a restriction due to lack of enforcement.

The excise taxes just described reflect the policy that assets transferred to a foundation must be used for exempt purposes and must benefit the public. One other excise tax, imposed by section 4940, is a tax on investment income. The tax was enacted to generate income to cover the cost of enforcement of the private foundation rules, but

[48] I.R.C. § 4941(d)(2). Examples of exceptions include reasonable compensation paid by the foundation to a disqualified person, an interest-free loan from a disqualified person to a foundation, and the furnishing of goods or services to the foundation by a disqualified person without charge.

[49] I.R.C. § 4946(a)(1) defines disqualified person.

[50] I.R.C. § 4943(a)(1) imposes a tax on excess business holdings; § 4943(c) defines excess business holdings; § 4943(c)(6) provides for a 5-year period to dispose of excess business holdings; and § 4943(c)(7) allows a foundation to request an additional 5-year period for disposition if the holdings are large or complex.

[51] I.R.C. § 4944.

the revenue was never appropriated for that purpose.[52] Initially set at 4 percent, Congress reduced the tax to 2 percent in 1978.[53] Section 4940 allows a private foundation to reduce the tax to 1 percent if the foundation increases distributions for its exempt purposes.[54]

The next section examines section 4942, the private foundation rule that requires a minimum distribution. In order to address the questions raised about warehousing, the next section examines what amount a foundation must distribute and what counts as a qualifying distribution.

C. Section 4942 – the Minimum Distribution Requirement

1. What Amount Must be Distributed?

Section 4942 imposes an excise tax if a private foundation does not distribute "enough" in the tax year being examined. The determination of "enough" involves a complicated set of definitions. First, the foundation determines its "distributable amount," which is the amount the foundation must distribute in that taxable year.[55] Then the foundation calculates the "qualifying distributions" it made during the year.[56] If the amount of the qualifying distributions equals or exceeds the distributable amount, all is well. If, however, the distributable amount exceeds the qualifying distributions, the foundation owes an excise tax of 30 percent of the excess amount.[57] Fortunately, the foundation has a year after determining the distributable amount to make the distributions,[58] and excess distributions made in one year can count toward the amount needed in another year.[59]

[52] FREMONT-SMITH, *supra* note 9, at 79.
[53] *Id*. at 84.
[54] I.R.C. § 4940(e).
[55] I.R.C. § 4942(d) defines "distributable amount."
[56] I.R.C. § 4942(g) defines "qualifying distributions."
[57] I.R.C. § 4942(a).
[58] *Id.*
[59] I.R.C. § 4942(i).

The distributable amount is defined as the "minimum investment return" reduced by any tax paid by the foundation under section 4940.[60] The minimum investment return is not, in fact, a return on investments. Rather, the amount is calculated as 5 percent of the foundation's assets other than assets used "directly in carrying out the foundation's exempt purpose," reduced by any acquisition indebtedness connected with the investment assets.[61] Assets excluded from the computation include administrative assets used in carrying out exempt purposes, program-related investments, and an interest in a business that is related to the purposes of the foundation in some way other than simply to create revenue for the foundation.[62] Section 4942 and its regulations contain rules for valuing assets.[63]

2. What Distributions Count Toward the Distributable Amount?

In addition to the section 4940 tax, any amounts spent on "reasonable and necessary" administrative expenses related to the foundation's grant-making activities count toward the required distribution amount.[64] Amounts used by the foundation directly for charitable purposes will count, but for most grant-making charities the bulk of the required distribution amount will consist of direct distributions (grants) to other charities. The easiest course for a foundation is to make grants to section 501(c)(3) organizations that qualify as domestic public charities. A distribution to a domestic public charity counts toward the required distribution amount as long as the public charity is not controlled by the foundation or by anyone who is a disqualified person of the foundation.[65] The

[60] I.R.C. § 4942(d).

[61] I.R.C. § 4942(e). For purposes of determining the minimum investment return, a foundation's assets exclude administrative assets used in carrying out exempt activities, so a large grant-making foundation that maintains an office where staff review applications and conduct oversight might own assets that should be excluded. If the administrative assets are used both for grant-related activities and for activities related to managing the foundation's investment assets, a reasonable allocation to the two types of uses must be made. Treas. Reg. § 53.4942(a)-2(c)(3).

[62] Treas. Reg. §53.4942(a)-2(c)(3). Section 4944(c) provides a definition of program-related investments and Treas. Reg. §53.4942(a)-2(c)(3)(iii) defines functionally-related business.

[63] I.R.C. § 4942((e)(2); Treas. Reg. § 53.4942(a)-2(c)(4).

[64] I.R.C. § 4942(g)(1)(A).

[65] *Id.*

foundation managers must exercise due diligence in making the grant,[66] but the managers need not get a legal opinion or exercise expenditure responsibility over the grant.

Other types of distributions may be possible but will require compliance with additional regulations. A distribution to a private operating foundation or a supporting organization may count, but additional rules apply.[67] A distribution to another private foundation will not be a qualifying distribution unless the private foundation makes a qualifying distribution equal to the amount received in the year following the receipt.[68]

A distribution to a foreign charity will count, but only if the foreign charity has received a ruling or determination letter from the IRS; the foundation making the distribution has made a good faith determination, called an equivalency determination, that the foreign charity would qualify as a U.S. charity if it were a U.S. charity; or the foundation exercises expenditure responsibility over the grant.[69] If the foundation wants to make a grant to a large established foreign charity, the foundation may be able to obtain written advice that the foreign charity would qualify as a public charity under U.S. tax rules. If, however, the prospective donee is recently established or carries out its purposes in an innovative manner, a tax practitioner may not be able to find sufficient information to make an equivalency determination. An alternative option for the foundation is to make a grant to a "friends of" U.S. organization that will send support to the foreign charity. Again, a new and innovative charity may be less likely to have a U.S. charity set up to support it. If an equivalency determination cannot be obtained and a U.S. organization does not exist, the foundation must exercise expenditure responsibility over the grant.[70]

Grants to individuals also may count toward the required distribution amount, if the purpose is to carry out the foundation's charitable purpose.[71] A charitable purpose might involve granting scholarships to individuals. If a grant to an individual is for "travel,

[66] In carrying out the purposes of the foundation, the managers would be bound by the fiduciary duties of obedience, care, and loyalty.
[67] *See* I.R.C. § 4942(g)(4) for additional requirements regarding supporting organizations.
[68] I.R.C. § 4942(g)(3).
[69] Treas. Reg. § 53.4942(a)-3(a)(6)(i). A foundation can rely on written advice from a qualified tax practitioner. Rev. Proc. 2017-53, which modified and supersedes Rev. Proc. 92-94, provides guidelines for making an equivalency determination.
[70] I.R.C. § 4945(d)(4)(B).
[71] I.R.C.§ 4942(g).

study, or other similar purposes," the grant will be a taxable expenditure unless the foundation obtains approval of the grant procedure in advance.[72]

If the private foundation wants to accumulate income in order to make a larger gift in the near future, the foundation may consider a set-aside. [73] An amount set aside for a specific project can be treated as a qualifying distribution if the project is one that requires the accumulation of money to be used at some time in the future.[74] For example, if the purpose is to build a new building, that purpose will be better accomplished by accumulating funds for several years before spending them rather than through annual distributions. If a foundation makes the required distributions using other funds, it can set-aside an amount for future use.[75] That amount will be treated as a qualifying distribution in the year in which it is actually distributed.[76]

Given the restrictions on most types of grants other than grants to domestic public charities, most foundations avoid the extra administrative and legal work (and costs) and make distributions to domestic public charities. Although the restrictions minimize the risk of abuse by donors seeking private benefit from their foundations, the additional requirements also make engagement in more active philanthropy more difficult.[77] Distributions above the minimum required amount may be less likely if options for how to carry out charitable purposes are restricted.

D. State Law Applicable to Spending by Private Foundations - UPMIFA

Another set of legal rules affects private foundations and the issue of warehousing. The Uniform Prudent Management of Institutional Funds Act (UPMIFA), enacted in all

[72] I.R.C. § 4945(d)(3), (g). To qualify, a grant must be of a type authorized in § 4945(g), which includes, for example, a scholarship to study at a college or university or a grant to achieve a specific objective, produce a report, or improve a skill or talent.

[73] I.R.C. § 4942(g)(2); Treas. Reg. 53.4942(a)-3(b).

[74] The "suitability test" is met if the foundation "establishes to the satisfaction of the Commissioner" that the project "can be better accomplished by the set-aside than by the immediate payment of funds." Treas. Reg. § 53.4942(a)-(3)(b)(2).

[75] *See* Treas. Reg. § 53.4942(a)-(3)(b)(2) (setting forth requirements for the "cash distribution test").

[76] *Id.*

[77] *See infra* Part IV.D.

states except Pennsylvania, provides guidance on the management, investment, and spending of funds held for charitable purposes.[78] UPMIFA usually does not apply to a funds held by a charity organized as a trust,[79] so the discussion in this section applies primarily to a private foundation organized as nonprofit corporation.

Under UPMIFA an "endowment fund" is any fund subject to UPMIFA[80] that is a donor-restricted fund and that is not wholly expendable on a current basis.[81] Although a donor could establish a foundation that could be liquidated within a year, that scenario is unlikely. Anyone going to the trouble of creating a foundation will presumably provide for distributions over time. Even a foundation with a fixed term will be intended to last longer than a year. Thus, UPMIFA applies to private foundations organized as nonprofit corporations. The UPMIFA rules, unlike the federal tax rules, are generally default rules that can be changed in the instrument governing the fund. Funds that predate UPMIFA will likely be governed by the UPMIFA rules, and not all private foundations will choose to draft around the rules.

[78] The Uniform Law Commission approved UPMIFA in 2006, and 49 states plus the District of Columbia and the Virgin Islands have adopted it. Pennsylvania has its own statute and restricts spending from endowments under that statute. *See* https://www.uniformlaws.org/committees/community-home?CommunityKey=043b9067-bc2c-46b7-8436-07c9054064a3 (last visited Aug. 25, 2019). The author served as Reporter for UPMIFA.

[79] UPMIFA § 5(B) excludes from the definition of institutional fund a fund held by a trustee that is not a charity (an "institution" in UPMIFA terminology). A trustee is typically an individual, a group of individuals or a corporate trustee, so UPMIFA does not apply to most charities organized as trusts. UPMIFA does apply to a charitable trust if a charity serves as its trustee.

[80] UPMIFA applies to "institutional funds," which are in essence investment funds held by charities organized as nonprofit corporations. Section 2(5) defines the term as follows:

> (5) "Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include:
>
> > (A) program-related assets;
> > (B) a fund held for an institution by a trustee that is not an institution; or
> > (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund.

[81] UPMIFA § 2(2). The term is defined as follows:

> (2) "Endowment fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.

When the Uniform Law Commission developed UPMIFA, a significant concern was to respect the intent of the donor who made a gift to an endowment fund.[82] UPMIFA changed the existing rule of construction with respect to endowments, removing a bright-line floor, called historic dollar value, that restricted spending under prior law.[83] UPMIFA replaced the concept of historic dollar value with directions to spend the amount determined to be prudent, after considering factors listed in the statute.[84] Any decision to spend from an endowment fund is "subject to the intent of a donor expressed in the gift instrument,"[85] and the decision-maker must consider "the duration and preservation of the endowment fund."[86]

The UPMIFA Drafting Committee emphasized the goal of preserving the endowment fund based on an assumption that donors want their gifts to an endowment to exist in perpetuity. A concern voiced during the drafting process was that if fund managers

[82] UPMIFA, Prefatory Note. "UPMIFA improves the protection of donor intent with respect to expenditures from endowments. . . . UPMIFA directs the charity to spend an amount that is prudent, consistent with the purposes of the fund, relevant economic factors, and the donor's intent that the fund continue in perpetuity."

[83] The Uniform Law Commission approved the Uniform Management of Institutional Funds (UMIFA) in 1972, and 47 jurisdictions enacted the Act. UPMIFA, Prefatory Note. UMIFA § 2 permitted the appropriation for expenditure of "so much of the net appreciation, realized and unrealized, in the fair value of the assets of an endowment fund over the historic dollar value of the fund as is prudent under the standard established by Section 6." Section 6 directed the managers to exercise "ordinary business care and prudence" in considering the needs and purposes of the endowment. UMIFA § 6. UMIFA defined historic dollar value as the amounts contributed to the fund, without adjustments for appreciation or inflation. UMIFA § 1(5). UMIFA focused on the spending of appreciation and was interpreted as meaning that a charity could spend ordinary accounting income plus appreciation above historic dollar value.

[84] UPMIFA § 4(a) provides as follows:

> (a) Subject to the intent of a donor expressed in the gift instrument [and to subsection (d)], an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:
>
> (1) the duration and preservation of the endowment fund;
> (2) the purposes of the institution and the endowment fund;
> (3) general economic conditions;
> (4) the possible effect of inflation or deflation;
> (5) the expected total return from income and the appreciation of investments;
> (6) other resources of the institution; and
> (7) the investment policy of the institution.

[85] *Id.*

[86] *Id.*

were able to do so, they would be tempted to spend the funds too quickly. The Act was drafted to reassure legislators and others that the change in the rule of construction was not intended to undermine the perpetual nature of endowments. The Comments explain, "Although the Act does not require that a specific amount be set aside as 'principal,' the Act assumes that the charity will act to preserve 'principal' (i.e., to maintain the purchasing power of the amounts contributed to the fund) while spending 'income' (i.e. making a distribution each year that represents a reasonable spending rate, given investment performance and general economic conditions)."[87] The Comments emphasize that a charity will not likely spend too quickly, noting that under the prior statute charities "have operated more conservatively than the historic dollar value rule would have permitted." The Comments then explain that "[s]everal levels of safeguard exist to prevent an institution from depleting an endowment fund. . . "[88] and that UPMIFA guides charities to make decisions that "attempt to ensure that the value of the fund endures . . . ."[89]

UPMIFA provided a new rule of construction for charities to carry out donor instructions to "spend only income" from an endowment. The Drafting Committee wanted to create a spending rule that was not tied to trust accounting income but worried that with flexibility fund managers would spend too much. In a private foundation the donor or the donor's family often makes the spending decisions, at least initially. A decision to spend or withhold income will comply with donor intent, if the donor makes the decision. Decisions for a public charity's endowment, in contrast, are typically made by managers and not by donors. With public charities primarily in mind, UPMIFA's rules were structured to discourage managers from spending too much. Although no bright-line rule prevents spending from an endowment, a manager "shall consider . . . the duration and preservation of the endowment fund."

The concerns about over-spending from an endowment were so great that the Drafting Committee included an optional provision designed to discourage over-spending.[90] Subsection (d) of Section 4 creates a rebuttable presumption of imprudence if

[87] UPMIFA § 4, Cmt.

[88] *Id.*

[89] *Id.*

[90] UPMIFA § 4(d), Cmt.

the managers of a fund spend more than 7 percent of the value of an endowment, calculated on a three-year rolling average.[91] Although the presumption is rebuttable, a governing board authorizing spending would likely be reluctant to spend above 7 percent, unless the documents creating the endowment provide for more rapid spending.[92] The Comments explain concerns that inclusion of the optional provision might actually lead to over-spending, if 7 percent were perceived as a safe harbor.[93] And the Comments add that "[e]xpenditures of 6 percent might well be imprudently high."[94] The theme throughout UPMIFA, emphasized in the Comments, is that a charity should not spend too much from its endowment fund.

Fewer than half the states adopted the optional presumption in subsection (d), probably due to concerns that it would be read as a safe harbor to spend up to 7 percent. Professor Brian Galle compared spending in states with the presumption with spending in states that did not adopt subsection (d). He found that charities in a state with the presumption were 30 percent less likely to exceed the 5 percent federal distribution requirement than charities in the other states. The presumption seems to have served not only to keep spending below 7 percent but to reduce it to be closer to 5 percent than it was before the enactment of UPMIFA.[95]

UPMIFA and section 4942 both address the problem of creating a rule that affects spending from a long-term charitable fund without using the term "income," because income can be manipulated and distorted.[96] Given that investment decision-making for endowments is influenced by modern portfolio theory and the concept of total return, spending a percentage of total assets is more appropriate than spending accounting income. Both UPMIFA and section 4942 seek to permit or require a stream of payments, while allowing the charitable fund to maintain value in the fund over time. Both UPMIFA and section 4942 do this by relying on a spending rate—a percentage of the asset value of

[91] UPMIFA § 4(d).
[92] UPMIFA § 4(d), Cmt.
[93] *Id.*
[94] *Id.*
[95] Galle, *supra* note 3, at 1201, appendix.
[96] For a discussion of principal and income in the trust accounting context, see RESTATEMENT (THIRD) OF TRUSTS § 110 (2012).

the fund—rather than a direction to "spend income and preserve principal."[97] For section 4942, the percentage is applied to investment assets and excludes assets used directly in charitable work.[98] For UPMIFA, the percentage is applied to the value of the fund, and the fund itself is limited to investment assets.[99]

The drafters of the two statutes approached the issue of spending by foundations with opposite purposes. For the UPMIFA drafters, the concern was to limit spending so the charity would not spend too much. For the section 4942 drafters, the concern was to require the charity to spend a minimum amount, with the concern that the charity would otherwise not spend enough. The differences lie in the reasons behind the two statutes. The tax rules apply only to private foundations and were created due to concerns about donors benefitting inappropriately from the private foundations they had created. The UPMIFA drafting process focused on public charities and concerns that managers would ignore donor intent.

The UPMIFA drafters chose not to require distributions from an endowment, and the Comments make clear that no minimum level of spending is required. A private foundation operating under UPMIFA will find it prudent to meet the 5 percent distribution rule, because to do otherwise would result in an excise tax. Endowments governed by UPMIFA that are not private foundations will follow the prudence standard to determine the amount to spend.[100]

[97] UPMIFA does not require distributions based on a spending rate but uses a percentage in its presumption of imprudence for spending too much. Endowments typically use a spending rate to comply with UPMIFA.

[98] I.R.C. § 4942(e) (defining "minimum investment return").

[99] *See* UPMIFA § 2(5) (defining "institutional fund").

[100] The Comments to UPMIFA § 4 explain, "[s]ubsection (d) does not require an institution to spend a minimum amount each year. The prudence standard and the needs of the institution will supply sufficient guidance regarding whether to accumulate rather than to spend in a particular year."

III. Policy Questions

A. Is Five Percent the Right Distribution Percentage?

One policy question is whether foundations should continue in perpetuity,[101] but before turning to that question, this section starts with an assumption that perpetuity is the goal. That is, if the goal is for a private foundation to spend some amount (an approximation of "income") and retain enough to maintain the value of the foundation in perpetuity, is 5 percent the right percentage for the minimum distribution requirement?

1. A Little More History

When Congress enacted the 1969 Act, section 4942 defined the distributable amount as the greater of the minimum investment return and the foundation's adjusted net income.[102] The minimum investment return was initially set at 6 percent, with a phase-in for existing foundations, and the Treasury was given the power to adjust the percentage.[103] The Treasury raised the rate to 6.75 percent for 1976, and the resulting outcry from foundations and their supporters led Congress to reconsider.[104] After hearing concerns that

[101] Brody, *supra* note 3, at 875. Brody examines university endowments and finds reports statements from many institutions and scholars that assume, usually based on the policy of intergenerational equity, that an endowment should be managed to maintain the real value of the endowment, after inflation. *Id.* at 930-33. She also describes Henry Hansmann's rejection of the intergenerational arguments with respect to university endowments. *Id.* at 933-35 (citing Henry Hansmann, *Why Do Universities Have Endowments*?, 19 J. LEGAL STUD. 3 (1990)). Brody concludes that article with the following:

> This Article suggests that the taste for perpetual charitable endowments persists as the happy coincidence of donors' desires for immortality for themselves and for their cultural beliefs, the professional staff's desire for employment and authority, and society's (apparent) desire for narrowly-controlled investment capital.

Brody, *supra* note 3, at 948.

[102] 4942 Impact, *supra* note 17, at 81. One of the reports had proposed a 25-year limited life for private foundations, and the distribution requirement was a compromise to force greater spending than had been the case for many foundations. *See* Byrnes, *supra* note 9, at 565.

[103] *Id.* at 82.

[104] *Id.* Dr. Robert F. Goheen, Chair and chief executive officer of the Council on Foundations, testified before Congress in 1973 that the 6% requirement should be lowered. John R. Labovitz, *The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements*, 3 J. LEGAL STUD. 63, 93 (1974). *See also* C. Eugene Steuerle, *Distribution Requirements for Foundations*, 70 PROC. ANN. CONF. ON TAX'N 423, 424 (1977) (arguing that the rate should not be more than 5%).

6 percent was unsustainable, and that the unpredictability caused by the adjustment power made investment planning difficult, Congress included amendments to section 4942 in the Tax Reform Act of 1976.[105] The amendments set the minimum investment return at 5 percent, and removed the power to adjust.[106] In 1981 Congress revised section 4942 again and removed the requirement that a foundation distribute a higher amount if its adjusted net income was higher than 5 percent of its investment assets.[107] That alternative distribution rule had created a perverse incentive to reduce income and may have affected investment strategies in unhelpful ways.[108]

Over the years reactions to the 5 percent rule have varied, with the focus typically on the long-term survival of the foundation and not on the optimal use of assets dedicated to charitable purposes.[109] The assumption that donors intend their private foundations to continue in perpetuity makes sense, given that a donor creating a private foundation could have chosen instead to make a gift directly to a public charity. The foundation choice likely represents a desire to retain control over the charitable assets and perhaps reflects a

[105] 4942 Impact, *supra* note 17, at 82. Report from the Committee on Ways and Means, Charitable Distribution Requirements for Private Foundations, 92d Cong. No. 92-791 (1972). The Report notes that the House version of the 1969 Act had a minimum distribution rate of 5%, but that rate was changed to 6% in the Senate. The House Committee concluded that the higher rate "may well have damaging effects of the continuing viability of many foundations." *Id.* at 3. The 1972 changes also reduced the phase-in percentages that had been from 4 ½ % to 5 ½ % to a phase-in from 3 ½ % to 4 ½ %. *Id.*

[106] 4942 Impact, *supra* note 17, at 82; Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1715.

[107] Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 823(a), 95 Star. 172, 351-52 (1981). The change was a reaction to the hyper-inflation that had resulted in 17% interest rates. Spending actual income would have meant spending into principal.

[108] Several uniform acts, all adopted widely, reflect the problem of tying distribution rules to income. The Uniform Prudent Investor Act (1994) adopts a portfolio approach to investing, based on modern portfolio theory. UMIFA (1972) and then UPMIFA (2006) use default spending rules for endowments based on a determination of the amount that is prudent rather than the amount determined to be income. And each version of the Uniform Principal and Income Act moves ever further from defining principal and income, giving a fiduciary authority to allocate between income and principal accounts when appropriate. *See* Joel C. Dobris, *Real Return, Modern Portfolio Theory, and College, University, and Foundation Decisions on Annual Spending from Endowments: A Visit to the World of Spending Rules*, 28 REAL PROP. PROB. & TR. J. 49, 53 (1993) (examining the experiences of colleges and universities in decoupling endowment spending from income).

[109] In 2004 Richard Schmalbeck reported that "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 2001, the typical nonoperating foundation with assets in excess of $100 million (which hold about 61% of all nonoperating foundation assets), distributed only a bit more than their legal minimums-the equivalent of a 5.4% distribution rate." Schmalbeck, *supra* note 36, at 89.

desire for immortality, or at least recognition, though a foundation named for the donor.[110]

2. Is Five Percent Too High?

Whether a private foundation can spend 5 percent a year and still sustain its value over time remains a question.[111] A study published in 1974, before the drop in the minimum distribution percentage to 5 percent, reported that foundation managers criticized the 5 percent minimum distribution rate then in effect as "a terrible blunder," "damaging to foundations in the long run," "just plain unreasonable," "unrealistic today from a purely income point of view," "an arbitrary selection in Congress, without study, that will cause foundations to self-destruct," and "punitive." [112] The report found that some of the problem may have been that foundation managers used to thinking about income and principal were slow to adopt total return investing.[113] Some of those managers shifted their investment portfolios to income producing investments so that they would not have to invade principal, and that shift resulted in lower overall returns.[114]

After Congress changed the percentage from 6 percent to 5 percent, complaints about the required minimum distribution requirement quieted. In the years that followed, foundations adopted total return investing, as that concept gained general acceptance.[115] The private foundations were subject to the required minimum distribution rule, so

[110] Carolyn B. Levine & Richard C. Sansing, *The Private Foundation Minimum Distribution Requirement and Public Policy*, 36 J. AM. TAX. ASSN. 166, 167 (2014).

[111] Congressman Patman was likely not concerned about whether the percentage requirement was sustainable. One proposal before Congress was to require private foundations to terminate after 25 years. The minimum distribution requirement was a compromise to force foundations to spend a not insignificant amount each year. *See* Byrnes, *supra* note 9, at 565.

[112] Labovitz, *supra* note 104, at 87.

[113] *Id. See* Moore, *supra* note 37, at 576. Moore's article provides an example of the misunderstanding: "This requirement poses a fairly obvious problem. If the trust contains stock that produces an income of 2 per cent, you must either distribute or sell some of the assets. In either case you are distributing corpus."

[114] Labovitz, *supra* note 104, at 92-93.

[115] In 1993 Joel Dobris describes total return investing as being "very much with us." Dobris, *supra* note 108, at 53. Dobris cites a study that found that 40% of the foundations in the survey reported distributing their investment income as they had traditionally done and only 7% reported using the mandatory 5% rate to set distributions. *Id.* at 66 (citing LESTER M. SALAMON & KENNETH P. VOYTEK, MANAGING FOUNDATION ASSETS, AN ANALYSIS OF FOUNDATION INVESTMENT AND PAYOUT PROCEDURES AND PERFORMANCE 2 (1989).

foundations could make distributions based on the percentage rate rather than on the income generated.

Two articles published by Professor Joel Dobris suggest that 5 percent may be too high if the goal is to maintain the value of a foundation over time. Although Professor Dobris focuses on private trusts, his examination of the idea of using a unitrust structure to determine distributions from a trust addresses the issues faced by foundations. His conclusion is that 5 percent is too high.

In a 1993 article, Joel Dobris examines the spending rates of college and university endowments, with the goal of providing guidance to private trusts on income and principal allocations.[116] He emphasizes the need to determine "real return," which he defines as return adjusted for inflation.[117] He explained that universities do this in constructing their spending procedures, because they want to "generate an income stream for generations. . . ."[118] Professor Dobris obtained information about spending policies from a number of colleges and universities and describes the variations in their approaches. He notes that "[m]ost modern 'spending rules appear designed to preserve the real value of the underlying endowment....'"[119] He finds that many, although not all, college and university endowments use these "modern rules."[120] Although Professor Dobris writes about university endowments, which are not required to spend a minimum amount, his analysis of real return and discussion of an appropriate spending rate provide useful information for private foundations.

Professor Dobris writes that in order to maintain an income flow for the purposes of the endowment and at the same time maintain the purchasing power of an endowment fund, the fund should spend "real return."[121] Professor Dobris cites a 1986 Cambridge Associates study that found that "expected real return for most balanced endowments falls

[116] Professor Dobris was then serving as co-Reporter to revise the Uniform Principal and Income Act and had become intrigued by the idea of using spending rates in private trusts, rather than relying on a determination of income to dictate distributions. Dobris, *supra* note 108, at 49.
[117] *Id.* at 55.
[118] *Id.* at 51.
[119] *Id.* at 54 (citing Cambridge Associates at 1).
[120] Dobris, *supra* note 108, at 55-61.
[121] *Id.* at 53-55. Dobris describes various spending policies used by colleges and university endowments. *Id.* at 54-61.

between 4.5% to 5.5% per year."[122] Professor Dobris then notes that "people who spend more than 4% of their own investment return . . . are probably eating into principal, often without realizing it."[123]

In a subsequent article, Professor Dobris directly considers factors to consider in determining the appropriate percentage.[124] This second article was in the context of the unitrust trend, and reflects his views that a unitrust is a bad idea and that spending 5 percent will deplete principal.[125] Professor Dobris writes about private trusts structured as unitrusts, but again, his comments about the spending rate can apply to private foundations. His general point is that if the goal is to maintain the value of a fund indefinitely, a fixed percentage spending rate is the wrong way to go "because the proper payout on assets is situational, and no percentage is ever going to be right for the long term."[126] He argues that because an appropriate payout for a specific fund would depend on the economy and the fund's individual return, any fixed percentage would have to be low.[127] The market will fluctuate, so a high number is too risky over time.[128] Professor Dobris concludes that if the goal is not to invade principal indirectly, the payout percentage should not exceed 3 percent.[129]

[122] CAMBRIDGE ASSOCIATES, INC., ANALYSIS OF UNIVERSITY ENDOWMENT SPENDING RATES 1 (1986) (cited in Dobris, *supra* note 108, at n. 18).

[123] Dobris, *supra* note 108, at 80. *See also* Schmalbeck, *supra* note 36, at 88-91. Schmalbeck agrees that distributions should be based on real rates of return and cautions against an increase in the required distribution percentage, at least until such time as economists determine "that real rates of return are permanently higher." *Id.* at 91.

[124] Joel C. Dobris, *Why Five - The Strange, Magnetic, and Mesmerizing Affect of the Five Percent Unitrust and Spending Rate on Settlors, Their Advisers, and Retirees*, 40 REAL PROP. PROB. & TR. J. 39 (2005).

[125] *Id.* at 43.

[126] *Id.* at 53.

[127] *Id.*

[128] *Id.* Dobris cites two surveys of foundation investment returns over a 10-year period. A Council on Foundations-Commonfund survey of 228 foundations found that returns over the 10-year period ending with 2015 fell in the 5.1-5.9 range. William F. Jarvis, Jared Powell & Kyle Kuhnel, *The Council on Foundations-Commonfund Study* (Aug. 23, 2016), https://cffiles.blob.core.windows.net/files/PressReleases/2016-0823-2015CCSF-PressRelease.pdf. The average return had been 15.6 for FY2013, dropping to 6.1 for FY 2014 and -0- for 2015. Cambridge Associates surveyed 445 endowment and foundation clients and found average returns of 4.97% for a similar 10-year period. *See* Marc Gunther, *Warren Buffett Has Some Excellent Advice for Foundations That They Probably Won't Take,* Foundation Center, Mar. 16, 2017, http://glasspockets.org/transparency-talk/warren-buffett-has-some…t-take?_ga=2.268646066.2139167868.1565047473-383612727.1565047473.

[129] Dobris, *supra* note 124, at 53-54. Dobris wonders why 5% became a default as a spending percentage. He notes that people have 5 fingers and think in multiples of 5. *Id.* at 62-63. He also reports that he found in a

Beginning with Delaware in 2001, states have adopted statutes permitting trusts to convert from a requirement to pay "income" to a beneficiary to a requirement to pay a unitrust amount instead.[130] Many of these statutes follow the I.R.C. section 643 regulations, which create a safe harbor for preferred tax treatment of the unitrust amount as income for tax purposes if the unitrust conversion statute requires the unitrust amount to be "no less than 3% and no more than 5% of the fair market value of the trust assets . . . ."[131] The regulations appear to assume that distributions in that range will allow the trustee to make distributions to the "income" beneficiaries while maintaining adequate "principal" for the remainder beneficiaries. The New York statute limits the unitrust percentage to 4 percent, reflecting a concern that spending more than 4 percent will erode principal.[132]

Alexander Wolf considers a different way to think about the optimal distribution rate.[133] He suggests that a lower distribution rate will maximize distributions for charitable purposes over the long-term. Mr. Wolf compared two endowments of equal size, one with a spending rate of 3.5 percent and one with a rate of 5 percent. The foundation spending 5 percent a year spent more in the early years, but after 24 years the foundation with the lower spending rate spent more in actual dollars. After 39 years the foundation with the lower rate had paid out more in total spending.[134]

book of numerology that Pythagoras regarded 5 as the number of Justice and astrologers connect the number 5 to Jupiter. *Id* at 97. Perhaps most relevant to private foundations, he comments that "five has an air of compromise." *Id*. at 60. Dobris argues that historical returns do not support a 5% spending rate. *Id*. at 68-72.

[130] *See* Richard W. Nenno, *The Power to Adjust and Total-Return Unitrust Statutes: State Developments and Tax Considerations*, 42 REAL PROP. PROB. & TR. J. 657, 671-76 (2008) (describing the statutes as of that time).

[131] Treas. Reg. § 1.643(b)-1.

[132] New York E.P.T.L. § 11-2.4.

[133] Alexander M. Wolf, *The Problems with Payouts: Assessing the Proposal for a Mandatory Distribution Requirement for University Endowments*, 48 HARV. J. ON LEGIS. 591, 622 (2011). Mr. Wolf was a Harvard law student when he wrote this Note.

[134] Wolf, *supra* note 133, at 619. Wolf notes that a comparison calculated by Charles Miller found that after 40 years a $100 million endowment with a spending rate of 4% would have paid more than a foundation of the same size with a rate of 5%. Id. (citing Charles Miller, Endowment Reform: Why Federal Mandatory Payouts Are Unnecessary, Legally Dubious, and Counterproductive to Larger Higher Education Reform, in CTR. FOR COLL. AFFORDABILITY & PRODUCTIVITY, UNIVERSITY ENDOWMENT REFORM: A DIALOGUE 5, 7 (2008), available at http://www.centerforcollegeaffordability.org/uploads/MillerMunsoncorrected. Mathematically, in a comparison of two distribution percentages the lower percentage should always yield more in distributions over time.

3. Is Five Percent Too Low?

A study completed by Professor Brian Galle suggests that many foundations could sustain spending at more than 5 percent. Professor Galle's study, covering over 21,000 foundations for the period 1985 to 2011, examined returns adjusted for inflation and found a mean of over 9 percent and a median of around 5 percent.[135] A median of 5 percent means that half the foundations surveyed would not be able to sustain spending above 5 percent, but Professor Galle favors increased distributions for charitable purposes even if an organization eventually dissolves.[136] His arguments for increased spending are discussed in Part IV.B.1.

4. Has Five Percent Become a Cap?

Some researchers have argued that removing the minimum distribution rule might actually encourage foundations to increase spending, or at least "to actually focus on the best distribution policy to pursue their mission."[137] They suggest that foundations perceive the 5 percent requirement as a cap.[138]

Anecdotal evidence supports this view.[139] I serve on an advisory board charged with making recommendations on grants by a private foundation. During a meeting to review the annual report, the accountant advised the board that a repositioning of the portfolio had resulted in capital gains. Those gains increased the investment income for the year, so the tax under section 4940 (the tax on investment income) was greater than usual. The tax

[135] Galle, *supra* note 3, at 1189. Galle's results depend on the years he chose for the study. Richard Schmalbeck reported in a 2004 article that "[e]conomists over the years generally have regarded the risk-free real rate of return on capital as being around 2%-3%." Schmalbeck, *supra* note 36, at 90. He acknowledges that stocks had had a "remarkable run" from the mid-1980s to 2000 but points out that there is no assurance that the market increases will continue. *Id.* Schmalbeck concluded that "[t]here is ample reason to believe that a 5% rate does adequately assure that the economic benefit of foundation capital is being devoted to charitable purposes." *Id.*

[136] Galle, *supra* note 3, at 1190. Galle notes that more small foundations fall below the 5% returns, and he suggests a solution could be to base the required distribution rate on the asset size of the foundation. *Id.*

[137] Daniel Halperin, *Tax Policy and Endowments-Is Excessive Accumulation Subsidized?,* 67 EXEMPT ORG. TAX REV. 125, 128 (2011).

[138] *Id.* (citing research by Akash Deep and Peter Frumkin).

[139] *See* Stephanie Strom, *How Long Should Gifts Just Grow*, N.Y. TIMES, Nov. 12, 2007, at HI.

counts toward the required minimum distribution amount, so the amount of grants needed to reach 5 percent amount was reduced. The accountant then said that we would need to reduce the grants for the year because the amount available for grants had been reduced. The accountant made this statement despite an increase in value in the portfolio. Although a foundation is legally permitted to make grants in excess of 5 percent, a board may be told that 5 percent is not just a minimum but also a cap.

In the states that have adopted UPMIFA's presumption of imprudence for spending above 7 percent,[140] that amount has become a de facto cap.[141] In addition, data show that foundations in those states have reduced spending to the federally required amount.[142]

B. Maybe the Premise is Wrong – Maybe Private Foundations Should Not Continue in Perpetuity

Although their rules serve different purposes, both federal and state rules operate from the premise that donors create private foundations with the intent that the foundations will continue in perpetuity. The federal rules may not have started with that premise,[143] and initially imposed an aggressive spending rate of 6 percent, but Congress responded to concerns that the 6 percent payout requirement initially enacted would result in "long term erosion of foundation capital"[144] by reducing the requirement to 5 percent. The Comments to UPMIFA emphasize the importance of following the intent of donors to an endowment, with the assumption that donors want the long-term continuation of the fund. Thus, both federal and state rules support the perpetual life of private foundations.

[140] *See* Part III.D.

[141] Galle, *supra* note 3, at 1201.

[142] *Id.*

[143] The spending rate seems to have been a compromise to avoid a time limit on private foundations. *See* Byrnes, *supra* note 9, at 565.

[144] Robert Goheen argued that if the goal is to permit foundations to maintain their current size, the 6 % rate was too high. He testified, "What this argument really suggests is that the importance of increased foundation payout
in the short run must be weighed against the long-term erosion of foundation capital when inflation in the charitable sector is taken into account." Labovitz, *supra* note 104, at n. 45.

The idea that endowments—both private foundations and endowments supporting public charities—should continue in perpetuity is an assumption that usually goes unchallenged.[145] Indeed, Professor Evelyn Brody has written, "Over the last millennium of Anglo-American philanthropy, perpetual endowments have only sporadically proved controversial. More commonly, the public views the income-only fund as a positive, if not the superlative, form of conducting charity."[146] Nonetheless, a policy question is whether legal rules should support the use of private foundations to hold assets for future charitable purposes or should instead require more immediate use of assets for which the donors have obtained tax deductions. This section considers some arguments that the assumption could be reconsidered, although legal changes that would force private foundations to spend more quickly seem unlikely.[147]

1. Policy Arguments for More Distributions

Professor Brian Galle argues that assets should be distributed more quickly than current rules require.[148] He notes that donors take tax deductions for gifts to private foundations, but the deductions do not reflect distributions for charitable purposes.[149] A donor can make a donation to a foundation, take an income tax deduction for the full value of the donation, and then restrict spending from the foundation so that distributions

[145] With respect to university endowments, Brody reports statements from many institutions and scholars that assume, usually based on the policy of intergenerational equity, that an endowment should be managed to maintain the real value of the endowment, after inflation. Brody, *supra* note 1, at 930-33. Those managing the endowments hold to this assumption, but others have argued that university endowments should increase spending. Henry Hansmann examines university endowments and rejects the intergenerational equity arguments. Henry Hansmann, *Why Do Universities Have Endowments*, 19 J. LEGAL STUD. 3 (1990).

[146] Brody, *supra* note 3, at 875.

[147] Brody concludes that "the taste for perpetual charitable endowments persists as the happy coincidence of donors' desires for immortality for themselves and for their cultural beliefs, the professional staff's desire for employment and authority, and society's (apparent) desire for narrowly-controlled investment capital." *Id.* at 948. Although written more than 20 years ago, Brody's happy coincidence seems unchanged.

[148] Galle, *supra* note 3, 1208. Galle recognizes that repeal of a tax deduction for gifts to private foundations is not likely. *Id.* at 1182. Instead he recommends an increase to the required distribution rate. *Id.*at 1192. He also suggests a decrease in the investment tax under section 4940 if a foundation increases spending. *Id.* at 1193-96.

[149] *Id.* at 1150.

for charitable activities dribble out over many years. The law supports the restrictions donors place on spending from foundations, through UPMIFA and other legal rules that protect donor intent.[150] The result, writes Professor Galle, is that "nearly a trillion dollars of philanthropic wealth now sits on the sidelines, held in abeyance not just for tomorrow, but for the indefinite future."[151] He argues that current spending would serve society better than delayed spending.[152]

Professor Galle describes the tax deductions donors receive as government investment in the charitable assets. In his view, "when the government gives foundations a dollar, the utility of future spending should equal or exceed the utility we could get from a dollar of present spending."[153] Professor Galle further explains that projects supported by current spending may themselves have perpetual life.[154] A foundation's grant might support a project that will be able to continue longer, strengthened by the infusion of money from the foundation. When a foundation supports a current program, society may receive benefits from the program for many future years.[155]

Professor Galle argues that if a foundation wants to maximize its charitable benefit over time, the foundation should consider the cost-effectiveness of a grant now as compared with a grant later.[156] Certain charitable purposes may be better accomplished with a larger infusion of money now. For example, if a foundation seeks to preserve open space, protecting open space now is likely to be more effective than trying to convert

[150] *Id.* at 1153. *See also* Susan N. Gary, *The Problems with Donor Intent: Interpretation, Enforcement, and Doing the Right Thing*, 85 CHICAGO-KENT L. REV. 977 (2010).

[151] Galle, *supra* note 3, at 1146.

[152] *Id.* at 1159.

[153] *Id.* at 1158. Galle states,

> to justify government support for restricted spending, foundation savings should have to beat two benchmarks. First, the utility payoff to future spending--net of all the costs and benefits that delay might bring--should exceed the government's investment opportunity: Second, the net payoff should exceed any returns that the foundation could achieve by spending now on projects whose useful life is expected to be just as "perpetual" as the foundation itself. *Id.* at 1158-59.

[154] *Id.*

[155] *Id.* at 1159-60.

[156] With respect to the charitable donees, Galle says, "restricted spending forces some operating charities to wait to obtain resources that in some cases could have been spent more efficiently in earlier periods." *Id.* at 1164.

developed property back into open space later.[157] Another example might be the cure for a disease. If the needed research is funded more quickly, perhaps the disease can be eradicated more quickly.

A further argument for preferring current spending over future spending is that if the charitable sector experiences significant growth in the near future, more funds will be available for the next generation than are currently available. If the next generation is likely to be wealthier or have access to more charitable funds, then spending more on the current generation will maximize charitable benefit across the generations.[158] This argument undercuts the intergenerational equity argument often made in support of perpetual endowments.[159]

2. Donor Interest in Spending More than Five Percent

a. Recent Donors Spend More

Evidence suggests that recent donors may be interested in distribution rates higher than those required by section 4942. Professor Galle's study compared payout rates of foundations that had received donations within five years before the year studied with payout rates of foundations that did not have recent donors.[160] The foundations with recent donors, who were presumed to be more likely to be actively involved, had significantly higher payout rates than foundations with no recent gifts.[161] The rates of

[157] This example comes from Michael Klausner, *When Time Isn't Money: Foundation Payouts and the Time Value of Money*, 41 EXEMPT ORG. TAX REV. 421 (2003).

[158] Galle, *supra* note 3, 1160-61; Klausner, *supra* note 157, at 57 (making this point and noting that "some expect a massive flow of funds to the nonprofit sector as the baby boomers pass on their wealth over the next 20 years.").

A related argument is that if future grants are discounted to present value, the value of current distributions greatly exceeds future distributions. *See* Paul J. Jansen & David M. Katz, *For Nonprofits, Time is Money*, THE MCKINSEY QUARTERLY, no. 1 (2002); Bill Bradley & Paul J. Jansen, *Faster Charity*, NEW YORK TIMES 23 (May 15, 2002). Klausner explains why this discounted cash flow approach is inapplicable to private foundation issues. Klausner, *supra* note 157, at 52-55.

[159] *See infra* Part IV.C.1. *See* Hansmann, *supra* note 109 (critiquing the intergenerational equity argument in the context of university endowments).

[160] Galle, *supra* note 3, 1161-62.

[161] *Id.* at 1162.

distribution for funds with recent gifts ranged from just below 10 percent to over 14 percent from approximately 1987 through 2012.[162] During the same period, funds without recent gifts spent around five percent.[163] Professor Galle suggests that active involvement by the donors may result in accelerated spending to carry out the donors' charitable goals. In contrast, non-donor foundation managers have incentives to increase the size of their foundations, because doing so serves to protect their jobs and provides a measure of the "success" of their foundations.[164]

b. Use of a Time Limit for a Foundation

Although the majority of foundations are created to last in perpetuity, a donor may prefer to impose a sunset provision, creating a limited-life foundation. In addition, the trustees of a perpetual foundation may decide to set a time for termination.[165] Studies have found that approximately 10 percent of foundations surveyed have chosen limited life.[166] These limited-life foundations will distribute their charitable funds more rapidly than section 4942 requires.

[162] *Id.*

[163] *Id.*

[164] *Id.* at 1164. *See also* Fleishman, *supra* note 3, at 149; Klausner, *supra* note 157, at 58 ("Foundation managers, however, seem to be influenced by the prestige associated with large endowments, and foundation donors seem to be influenced by notions of immortality associated with perpetual existence."). Managers have been described as being "more concerned with investment banking than with grant-making." Levine & Sansing, *supra* note 110 (citing P. Mehrling, *Spending Policies for Foundations: The Case for Increased Grants Payout*, National Network of Grantmakers (1999).

[165] The Atlantic Philanthropies, established in 1982, decided in 2002 to limit its life to a fixed term. *Our Story*, The Atlantic Philanthropies, https://www.atlanticphilanthropies.org/our-story (last visited Oct. 10, 2019).

[166] Mark Neithercut, *Is Perpetuity Too Long? Family foundations Can Increase Impact with Sunset Dates*, 9 FAMILY FOUNDATION ADVISOR (Council on Foundations: Jul./Aug. 2010). Of the 1,074 family foundations surveyed by the Foundation Center, 63% chose perpetuity, nearly 12% had chosen limited life, and 25.42% were undecided. A 2003 Urban Institute survey of 850 staffed foundations reported that 76% planned perpetuity, 8% planned limited life, and 16% were undecided. Francie Ostrower, *Limited Life Foundations: Motivations, Experiences, and Strategies* 2 (Urban Institute: 2009). A 2004 Foundation Center survey of 697 foundations identified 9% as choosing limited life. *Id.*

In 1929 Julius Rosenwald published an essay announcing his opposition to perpetual foundations.[167] His own foundation, the Julius Rosenwald Fund, was to be spent down within 25 years of his death.[168] One of Congressman Patman's reports used Rosenwald's ideas to advocate for a 25-year limit on foundations, but Congress did not adopt a time limit.[169] After the 1969 Act, the idea of creating non-perpetual foundations lay dormant for some years.

The Olin Foundation, established by John M. Olin on his death in 1982, terminated 23 years later, in compliance with his instructions.[170] He wanted his trustees, all approximately a generation younger than he was, to spend the assets of the foundation during their working lifetimes.[171] The trustees were mostly Mr. Olin's business associates, and he trusted them to carry out his vision for the use of the foundation's assets.[172] Mr. Olin was influenced by Mr. Rosenwald's writings and by two concerns. First, he worried that future trustees might change the direction of the foundation. Second, he wanted to put assets to work on current problems, specifically "to influence contemporary thinking about economics and public policy, in the hope that the severe problems he saw could be corrected…."[173] These two concerns—mission drift and using charitable funds for current, identifiable needs—continue to influence donors who choose to provide an end date for their foundations.

A study[174] conducted by Francie Ostrower and published in 2009 reported that the first concern, mission drift, was the reason given by a majority of the foundations surveyed that had chosen limited life.[175] This reason was identified by donors and also by foundation trustees, who worried that the donor's likes and dislikes would be harder to

[167] FLEISCHMAN, *supra* note 3, at 104 (quoting from Rosenwald's Saturday Evening Post essay).
[168] *Id.* 103.
[169] *See* Byrnes, *supra* note 9, at 565.
[170] FLEISCHMAN, *supra* note 3, at 121.
[171] *Id.* (quoting from James Piereson, *Switching Off the Lights at the Olin Foundation*, PHILANTHROPY (Mar./Apr. 2002), http://www.philanthropyroundtable.org/site/print/the_insiders_guide_to_spend_down).
[172] FLEISCHMAN, *supra* note 3, at 121.
[173] *Id.* at 120-21.
[174] The study used data collected from 850 private foundations for a 2003 Urban Institute survey and data collected from interviews conducted from 2007-2008 with foundation CEOs and board chairs of about 30 private foundations. Ostrower, *supra* note 166, at 2-3.
[175] *Id.* at 5 (noting that findings of the study were consistent with the argument that limiting foundation life "promotes adherence to donor intent").

ascertain over time, especially where the donor had left no guidelines for the foundation.[176] The survey found that of foundations with deceased donors, 91 percent of limited life foundations reported donor intent as very important, compared with only 65 percent of perpetual foundations.[177]

Mission drift has gotten the attention of conservative commentators who worry that foundations will "stray from their original mission and move to funding liberal organizations."[178] Professor Joel Fleishman reports that Civitas Institute and the Philanthropy Roundtable have written about the risk that that a foundation will veer from a founder's conservative principles to the liberal philosophies of successor trustees.[179] The two organizations encourage donors to impose time limits on their foundations to avoid this sort of change.[180]

The concern over the potential for mission drift is not limited to donors motivated by conservative causes. Donors with all sorts of charitable visions may be concerned that after the donor's death the foundation will be used to support causes the donor would not have supported. With that concern in mind, Bernard Marcus directed that the Marcus Foundation be spent down within 20 years after his death.[181] In addition, he left the trustees who would run the foundation after his death with a list of the projects or causes the foundation should support and those it should not support.[182] Another donor, Zalman

[176] *Id.* at 8.
[177] *Id.* at 5.
[178] FLEISCHMAN, *supra* note 3, at 127 (citing a post on the Civitas Institute website that accused the Z. Smith Reynolds Foundation of attacking free enterprise and warned readers about groups that engage in "extreme and sometimes radical progressive activism").
[179] *Id.* at 127-28.
[180] *Id.* at 127-31 (citing a post on the Civitas Institute website that accused the Z. Smith Reynolds Foundation of attacking free enterprise and warning readers about groups that engage in "extreme and sometimes radical progressive activism"). *See also* Francies Ostrower, *Foundation Life Spans: A Vexing Issue*, 21 CHRON. OF PHILANTHROPY (May 21, 2009) (noting that the Philanthropy Roundtable urges foundations to include a sunset provision). Although some foundations may shift directions over time, some donors do not limit their foundations to a particular type of activity or grant. Fleishman notes that Adam Meyerson of the Philanthropy Roundtable criticizes John D. MacArthur and John D. Rockefeller for failing to be specific about the purposes of their foundations. MacArthur gave his trustees no instructions, and Rockefeller's mission statement for the Rockefeller Foundation was "to improve the well-being of mankind throughout the world." FLEISCHMAN, *supra* note 3, at 132. A foundation may have been created with a broad purpose statement because the donor understood that needs would change over time. *Id.* at 133.
[181] FLEISCHMAN, *supra* note 3, at 145.
[182] *Id.*

Bernstein, did not specify a spend-down date when he created the AVI CHAI Foundation, but during his life he had expressed concerns about changes made to foundations' purposes. A few years after his death the trustees decided that his foundation would be spent down by a December 31, 2019, 20 years after his death.[183]

Despite publicized concerns about mission drift, many foundations carry out the wishes of their donors.[184] Professor Fleishman writes that "[t]housands of foundations that were founded by now-deceased donors do not appear to have wavered to any significant degree in trying to fulfill the intentions of their founders…."[185] For some foundations, the donor's directions may be intentionally broad, to allow the fiduciaries to keep pace with changes over time. As Andrew Carnegie wrote when he created the Carnegie Corporation:

> Conditions upon the [earth] inevitably change; hence, no wise man will bind Trustees forever to certain paths, causes or institutions. I disclaim any intention of doing so. On the contrary, I [give] my Trustees full authority to change policy or causes hitherto aided, from time to time, when this, in their opinion, has become necessary or desirable. They shall best conform to my wishes by using their own judgment.[186]

Reasons other than mission drift influence foundations to choose limited life. The second reason, a desire to address current problems and let future generations deal with future problems, also influences donors to create foundations with time limits.[187] A donor may believe that a foundation will have a greater impact on causes that matter to the donor if the foundation allocates significant amounts quickly. The rapid expenditure of funds from the Aaron and Irene Diamond Foundation greatly influenced AIDS research at a critical time for that work.

[183] *Id.* at 144-45.

[184] *Id.* at 134. Fleishman lists a number of well-known foundations "that exemplify adherence to expressed donor intent…." *Id.* at 134-35.

[185] *Id.* at 134. He lists a number of well-known foundations "that exemplify adherence to expressed donor intent…." *Id.* at 134-35.

[186] Andrew Carnegie's Deed of Gift to the Carnegie Corporation, Nov. 10, 1911.

[187] The examples that follow make clear that some donors believe their philanthropy will have greater impact if they make distributions more quickly than a limited life foundation would permit, but the Ostrower survey heard this view as a motivation for a limited life foundation from only a few interviewees. Ostrower, *supra* note 166, at 9.

When Aaron Diamond died in 1984, the Diamond Foundation, worth $200 million, was designed to be spent down within about 10 years.[188] In the 1980s, when AIDS was untreatable and a diagnosis was a death sentence, the foundation made grants of $50 million to AIDS research, including the establishment of the Aaron Diamond AIDS Research Center.[189] Researchers at the Center developed the "AIDS cocktail," a treatment that allowed patients to live with AIDS.[190] Other grants supported education about AIDS prevention.[191] The foundation terminated at the end of 1996, having had a significant impact on AIDS research.[192]

One of the largest charities to operate as a limited-life foundation, the Atlantic Philanthropies will have spent over $8 billion in grants when it closes in 2020, after 37 years of grant making.[193] Chuck Feeney, an entrepreneur who decided to dedicate his fortune to charitable purposes, founded the organization in 1982.[194] The organization's website describes his philosophy as Giving while Living, "an entrepreneurial approach to philanthropy by which you actively devote your money, skills and time to make a difference sooner rather than later. You can learn and make adjustments to get the biggest bang–and impact–for your buck."[195]

Although no time limit was set when the organization was founded, the trustees adopted a time limit in 2002, in keeping with Mr. Feeney's philosophy.[196] The website explains: "Because we believe that it's imperative to address deeply rooted problems sooner than later, many of our grants were 'big bets' designed to bring lasting improvements to people's lives."[197] The organization says that it has "demonstrated the

[188] *Id.* at161, Appendix A; Ernest Tollerson, *Charities Debate Tactic to Limit Gifts' Life Span*, N.Y. TIMES, Dec. 19, 1996.
[189] FLEISCHMAN, *supra* note 3, at 161.
[190] *Id.*
[191] *Id.*
[192] Tollerson, *supra* note 188.
[193] *Our Story*, The Atlantic Philanthropies, https://www.atlanticphilanthropies.org/our-story (last visited Oct. 10, 2019).
[194] *Id.*
[195] *Giving while Living*, The Atlantic Philanthropies, https://www.atlanticphilanthropies.org/giving-while-living (last visited Oct. 10, 2019).
[196] *Our Story*, The Atlantic Philanthropies, https://www.atlanticphilanthropies.org/our-story (last visited Oct. 10, 2019).
[197] *Id.*

benefit of taking steps to solve intractable problems before they became entrenched, and more expansive and expensive."[198] In addition to the goal of working on problems quickly, the Giving while Living philosophy provides "the immense satisfaction of not only making a difference but seeing it happen now."[199] And as Mr. Feeney has said, "It's a lot more fun to give while you're alive, than to give while you're dead."[200]

Mr. Feeney's philosophy and work with the Atlantic Philanthropies has influenced other donors, including Bill and Melinda Gates and Warren Buffett. When established in 2000, the Bill and Melinda Gates Foundation announced that it would terminate 50 years after the death of the second to die of its founders. In 2012 the foundation announced that it had changed the termination date to 20 years after the deaths of the founders.[201] For now, the foundation distributes amounts comparable to the amounts a perpetual foundation would spend. The foundation makes the required 5 percent distribution each year, and in addition, the foundation must spend the proceeds of the sale of the stock given to the foundation by Warren Buffett, as stipulated in the gift from Mr. Buffett.[202] For 2015 the required grant-making came to about $3.9 billion.[203] The projected spend-down date is still far in the future, assuming reasonable life expectancies for Bill and Melinda Gates (born in 1955 and 1964 respectively).[204]

Other concerns, such as corruption and sclerosis, may cause a founder to create a limited-life foundation. If a foundation continues in perpetuity, at some point the founder and immediate family members will no longer be able to provide oversight for the management of the foundation. Foundation managers or fiduciaries might be tempted to take private benefits from the foundation. The mission might be the same, but the

[198] *Id.*

[199] *Giving while Living*, The Atlantic Philanthropies, https://www.atlanticphilanthropies.org/giving-while-living (last visited Oct. 10, 2019).

[200] *Id. See also* Neithercut, *supra* note 166 (listing sunset date, impact, fulfillment, and proximity as benefits of limiting the life of a foundation); Ostrower, *supra* note 166, at 9 (reporting that for some donors a decision to sunset a foundation "was strongly tied to a sense of personal commitment and enjoyment of their philanthropy.").

[201] FLEISCHMAN, *supra* note 3, at 145.

[202] *Id.* at 177-78. The stipulation was likely included for tax reasons that probably do not apply to Mr. Buffett, who presumably cannot make use of an income tax deduction for his gifts.

[203] *Id.* at 177.

[204] *Id.* at 178.

handling of grants might yield private benefits that divert foundation assets from the charitable purposes. Other foundations might be free of corruption, but for larger foundations, as time continues the administrative bureaucracy that develops around grant-making and other activities can take assets away from the charitable purposes. Neither of these problems is inevitable, but both may cause a donor to think about a time limit.

C. What about Advantages of Perpetuity – or at Least Long-term Existence?

Several arguments point to the benefits to society of a pool of charitable assets held for the long-term. Historically, holding assets in a fund for both current and future use has been a well-accepted means of accomplishing charitable goals.[205] Advocates for perpetual foundations have identified various advantages of holding charitable funds for future use, rather than spending all of the funds currently.

1. Intergenerational Equity

A common argument for maintaining perpetual foundations is intergenerational equity.[206] A distribution rate of 5 percent should allow some funds to be used currently while preserving the foundation to be able to make grants into the future.[207] A private foundation may be better able to respond to intergenerational equity concerns than would a public charity, because a public charity relies on current donors and may face pressure to show results in addressing current problems.[208] With its reserve of funds, a foundation or other endowment can respond to needs both now and in the future. Economics Professor James Tobin has made this point, writing, "The trustees of endowed institutions are the

[205] Brody, *supra* note 3, at 937 ("The abstract conception of a charitable donation as yielding a perpetual stream of fruits persists in the Anglo-American collective consciousness as the highest form of conducting charity").

[206] Galle, *supra* note 3, at 1169.

[207] Klausner, *supra* note 157, at 58 ("In the long run, the minimum payout requirement is expected to hold foundation endowments constant . . . "). UPMIFA takes this approach.

[208] Levine & Sansing, *supra* note 110, at 166.

guardians of the future against the claims of the present. Their task in managing the endowment is to preserve equity among generations."[209]

2. Source of Investment Capital

Foundations also serve as a source of investment capital for charitable purposes. By providing the income tax deduction for initial gifts, the tax system encourages gifts that might be larger than they would be otherwise, increasing the amount of investment capital set aside for charity. Thus, the foundation becomes a saving tool for society, a way to save for future charitable purposes.[210] With this pool of assets, foundations can act as angel investors, supporting innovative ideas that do not yet have the track record necessary to obtain current donations or government funding. Professor Fleishman describes the role the Ford Foundation had in providing start-up and then sustaining support for the Natural Resources Defense Council and the Environmental Defense Fund.[211] Both organizations now have broad-based membership support for activities that include research, public policy work, and the creation and enforcement of federal and state legislation.[212] Their continuing work confers "extraordinary benefits on America, a very significant return on the investment capital provided by the Ford Foundation."[213]

3. Thoughtful, Systematic, and More Effective Use of Charitable Funds

Another advantage of a perpetual private foundation when compared with direct gifts or short-term endowments, is that grants from a foundation can be made thoughtfully, over a period of time. The foundation managers can investigate donees and

[209] James Tobin, *What Is Permanent Endowment Income?* AM. ECON. REV. 64 No. 2 (1974).
[210] Brody describes this idea as stewardship for future generations: "Accordingly, we turn to notions of "stewardship," and how society uses charitable endowments to save. By focusing on where the principal goes, rather than on where the income goes, we can see that endowments (and other surpluses) provide a large pool of investment capital to society." Brody, *supra* note 3, at 929.
[211] FLEISCHMAN, *supra* note 3, at 6-7.
[212] *Id.* at 7.
[213] *Id.*

create a systematic grant program that may be more effective than rushed gifts.[214] The foundation can learn from its grant-making and fine-tune its efforts as it learns. A foundation might develop expertise in a particular type of grant-making and be able to do a good job of evaluating grant applications. A large foundation might have economies of scale that would make its grant-making more efficient.[215]

A foundation that seeks to tackle large social problems may need many years of incremental work to find a solution. Professor Fleishmann describes this type of a foundation, and its benefits, as follows:

> They exist to work on solving big problems over many years, step-by-step, in an iterative way that allows them to fine-tune what they are doing based on what they are learning about their progress by trial and error. A long life and deep pockets give them the opportunity to learn how to adjust when they make mistakes and otherwise stay the course until they find the silver bullet that solves the problem.[216]

4. Encouragement for More Charitable Giving

A different argument in favor of perpetuity focuses on donor intent. If a donor chooses perpetuity, the donor should be entitled to perpetuity.[217] A more persuasive argument involving donors is that a donor may be more willing to give to a private foundation, and therefore ultimately to charity, if the donor's intent for the gift can be preserved, theoretically, in perpetuity.[218] A donor may be encouraged to give more if the

[214] In an article written before the 1969 Act, Duhl cautioned against a requirement that foundations spend all their income as quickly as they received it, saying "they must be allowed to search for an intelligent disposition of funds." Duhl, *supra* note 14, at 505.

[215] FLEISCHMAN, *supra* note 3, at 245-46.

[216] *Id.* at 180.

[217] The fiduciary duty of obedience requires the fiduciary to carry out the settlor's intent. RESTATEMENT (THIRD) OF TRUSTS § 76 (2007).

[218] Brody argues that the perpetual nature of endowments encourages giving. She writes,

> Laws enforce perpetual funds for charity because to do otherwise would discourage gifts. Implicitly the state has determined that net social welfare increases by permitting the dead hand of the testator to govern the enjoyment of wealth into perpetuity. In deciding between devoting their property to perpetual charitable use and keeping it in the family, donors take into account the likelihood that their donated property will remain governed by their wishes. . . . But any legal limitation on donor authority will reduce the value of the charitable bequest, both absolutely and relative to the value of an alternate devise. Brody, *supra* note 3, at 942-43.

donor can seek recognition by naming the foundation for the donor or the donor's family. A donor may also gain a certain amount of power and influence in the community by virtue of controlling a large fund available for grants.[219] All of these benefits to the donor may increase the assets available to charity eventually.[220]

D. Do the Spending Rules Discourage New Types of Philanthropy

If the policy behind the private foundation rules is to maximize public charitable benefit, the application of the rules should be examined against new strategies for philanthropy. Although UPMIFA is primarily default law, and a donor can change the application of UPMIFA, UPMIFA affects foundations as a signal that they should not spend too much, even if it does not legally restrict their activities. The private foundation rules are mandatory and may have a chilling effect on certain types of philanthropy.

If an individual donor wants to create a foundation to do good in the world, the donor has a number of options. The donor can make a direct gift to a public charity, but then the donor loses control over the gift. A donor can place restrictions on a gift, but a donee charity may balk if the restrictions appear too limiting. The donor will not be able to adjust the gift later, as changes make alternative purposes or uses more appealing.

See also Renee A. Irvin, *Endowments: Stable Largesse or Distortion of the Polity?,* 67 PUB. ADMIN. REV. 445, 449 (2007). Brian Galle notes that no empirical evidence exists to confirm that donors give more when they can provide for a charitable gift in perpetuity, but even if that assertion is true, the assertion might suggest that lower tax benefits are necessary to encourage more gifts. Galle, *supra* note 3, at 1169-70. Galle says, "If donors want to give more when their gifts can be subject to restricted-spending rules, government's support in dollars can be lower." *Id.* at 1170.

[219] Galle, *supra* note 3, at 1151.

[220] A study conducted by Levine and Sansing compared the effect that an increase in the distribution requirement would have on the creation of private foundations. Their study found that as the distribution requirement increased, the number of donors who chose to create a foundation would decrease. They noted that the foundations that were created would be required to distribute more, with the result that the effect of an increase in the distribution requirement on the present value of distributions was "ambiguous." Levine & Sansing, *supra* note 110, at 167.

A donor can also choose to make a gift to a donor-advised fund. Donor advised funds have soared in popularity in recent years.[221] They are an attractive alternative to a private foundation, because a donor advised fund allows a donor to avoid the costs of establishing and running a separate foundation. The donor-advised fund is a public charity, so it is not subject to the private foundation rules, including the required distribution rule of section 4942. Thus, if a donor wants to accumulate funds for future charitable purposes, a donation to a donor advised fund is a good strategy. With a gift to a donor-advised fund, the donor may recommend grants from the donor's account, but grants can be made only as approved by the donor-advised fund, and the donor-advised fund has ultimate control over the assets. The donor-advised fund may be the right vehicle for a donor who wants to get an income tax deduction immediately for gifts to be made in the future. However, if the donor wants the maximum amount of ongoing control and likes the idea of perpetuity, the donor may prefer to establish a private foundation to carry out the donor's philanthropic ideas.[222]

One other alternative to a private foundation would be to establish a social welfare organization, exempt from tax under section 501(c)(4).[223] A social welfare organization can be used to make charitable grants, and it can be used for other activities if desired. If the donor does not need or cannot benefit from the income tax deduction for the gift to the foundation, a social welfare organization will provide a great deal more flexibility for

[221] U.S. Gov't Accountability Office, *Tax-Law Enforcement: IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities*, Report to the Committee on Finance, U.S. Senate (Sept. 2019), at 15 (citing a National Philanthropic Trust study that reported $29 billion in contributions in 2017 and $110 billion in assets held by DAFs). *See also* Kate Harris and Daniel Hemel, *Don't Delay Deductions for Gifts to Donor-Advised Funds*, CHRONICLE OF PHILANTHROPY (Oct. 7, 2019); Roger Colinvaux & Ray Madoff, *A Donor-Advised Fund Proposal That Would Work for Everyone*, CHRONICLE OF PHILANTHROPY (Sept. 23, 2019) (describing DAFs as a "fundraising phenomenon" and recommending that the income tax deduction for a gift to a donor-advised fund be delayed until a distribution is made from the fund to a charity).

[222] Levine & Sansing, *supra* note 110, at 167, stating,

> Public charities can and do have endowments, and the private foundation sector has no apparent comparative advantage in investing assets now in order to make larger charitable expenditures in the future. Instead, the establishment of a private foundation suggests a desire to retain control of foundation assets, even though the ultimate beneficiaries of these assets are §501(c)(3) public charities.

[223] *See supra* text accompanying notes 4-8.

the donor when compared with a private foundation. The private foundation rules do not apply, so there are no limits on investments and no distribution requirement.

An individual donor may want more control than a gift to a donor advised fund will provide and may want an income tax deduction for the gift, so the donor may choose to create a private foundation. If so, the donor's ideas for carrying out philanthropic goals may run up against the private foundation rules. A question is whether the law should encourage these new strategies or continue to restrict behaviors based on concerns dating back to the 1960s. From a policy standpoint, some of these strategies would seem to be good public benefit tools. There are a number of specific issues.

1. Interest in Direct Action through Impact Investing

A foundation may want to further its charitable purposes by making an impact investment. The term impact investing is sometimes used as a generic term to encompass various types of investing that combine traditional financial goals with social and environmental goals.[224] The term impact investing has a more specific meaning, and that is the meaning used in this paper. As used in its specific sense, the term means investing in selected projects or companies to have an impact on a particular social or environmental issue.[225] An impact investor invests in a project or a company with two goals: the social or environmental benefit the project will create and the financial return on the investment. The investor considers the social or environmental benefit as part of the investment, to be considered together with the financial return to determine whether the investment has generated value for the investor.[226]

[224] For discussions of impact investing and other forms of sustainable and responsible investing, see Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 UNIV. OF COLORADO L. REV. 731 (2019); Susan N. Gary, *Values and Value: University Endowments, Fiduciary Duties, and ESG Investing,* 42 J. OF COLLEGE & UNIV. L. 247 (2016).

[225] *See* ANTONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE (Jossey-Bass, 2011); Commonfund Institute, *From SRI to ESG: The Changing World of Responsible Investing* (2013).

[226] For an explanation of impact investing, see ANTONY BUGG-LEVINE & JED EMERSON, *supra* note 225.

Some impact investors may willingly and intentionally sacrifice some amount of financial return to obtain more non-financial benefit. They may be referred to as "impact-first." Other impact investors, referred to as "finance-first," may want to maintain financial returns that match financial benchmarks. For a private foundation, the difference between impact-first and finance-first will affect whether the investment is considered a program-related investment or a mission-related investment. Impact investment raises a number of concerns for foundations.

a. Jeopardizing Investments

Section 4944 imposes an excise tax on a private foundation that "invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes…."[227] This section, commonly referred to as the "jeopardizing investments" section, does not explain what a jeopardizing investment is, and the regulations are unhelpful. The regulations contain language from the prudent invest rule and direct the manager to exercise "ordinary business care and prudence."[228] Section 4944 has not been enforced, so little guidance as to what might be "jeopardizing" exists. The lack of guidance may make a manager nervous about engaging in an innovative business venture. A new company established to build a new product in line with a foundation's mission could seem problematic. Even though it might have greater-than-market risk, it might still be an appealing investment that could provide both financial return and mission-related return. Investments related to the foundation's purposes can be made without causing imposition of a section 4944 excise tax, but the rules and process make doing so difficult.

[227] I.R.C. § 4944(a)(1). Section 4944(a)(2) imposes a tax on a foundation manager who participated in making the investment knowing that it would jeopardize the foundation's exempt purposes. For an examination of the legislative history of 4944 see Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59, 70-73 (2004).

[228] Treas. Reg. § 53.4944-1(a)(2)(i).

b. Program-Related Investments (PRIs)

To permit a foundation to use assets for its program in a manner that results in some financial return, section 4944 includes an exception for a program-related investment (PRI).[229] An investment must be made primarily for program purposes in order to qualify, and production of revenue cannot be a significant purpose.[230] The regulations explain that an investment is made primarily for program purposes "if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities."[231] The investment may produce income or capital gain, as long as the production of revenue is not a significant purpose for the foundation.[232] If an investment qualifies as a PRI, the foundation benefits in two ways: the investment is not a jeopardizing investment and the investment is excluded from the investment assets on which the 5 percent distribution amount is computed.[233]

Although the PRI exception seems to provide an interesting option for foundation managers, a survey conducted by Professor Galle and published in 2016 found that few foundations—"barely one-tenth of 1% of foundation assets" in his sample—use PRIs.[234] The problem for a foundation is that unless the foundation is certain that an investment with lower earnings potential complies with the PRI rules, the foundation may be reluctant to make the investment.

[229] I.R.C. § 4944(c).

[230] *Id.*

[231] Treas. Reg. § 53.4944-3(a)(2)(i).

[232] Treas. Reg. § 53.4944-3(a)(2)(iii) ("the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.").

[233] Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d).

[234] Galle, *supra* note 3, at 1198.

The Low-Profit LLC (L3C) was developed to encourage foundations to use PRIs.[235] The idea was that an investment in an L3C would be treated as a PRI because the statutory requirements mirror the PRI requirements in section 4944(c).[236] The problem has been, however, that the L3C is a creature of state law and state law cannot control a determination of whether an investment complies with the PRI requirements for purposes of 4944.[237] The L3C idea does not seem to have spurred more PRIs, as Professor Galle's survey confirms. A foundation considering an investment in any type of PRI will likely get an opinion letter or even a ruling before proceeding.[238] The risk of an excise tax may make engaging in innovative investments more difficult.

c. Mission-Related Investments (MRIs)

As Professor Galle's survey reveals, few foundations use PRIs to carry out their mission.[239] Some charities, however, invest in ways that support their mission, with investments that are not made primarily for mission.[240] A foundation might choose an investment both for investment returns and for mission-related benefits. If the investment is not made primarily for mission or has financial return as a significant goal, the

[235] Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion*, 63 ARK. L. REV. 243, 244 (2010); Edward Xia, *Can the L3C Spur Private Foundation Program-Related Investment*, 2013 COLUM. BUS. L. REV. 242, 255 (2013). For a description and history of the LC3 see Bishop, at 246-51, Xia, at 247-51.

[236] *See* Bishop, *supra* note 225, at 250 ("the L3C statutory operating restrictions are designed as an ipso facto proxy for PRI status"). *See, e.g.,* VT. STAT. ANN. tit. 11, § 3001(27). The statute provides that an L3C "significantly furthers the accomplishment of one or more charitable or educational purposes" and "would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes" and includes the other requirements of a PRI. VT. STAT. ANN. tit. 11, § 3001(27).

[237] *See* Bishop, *supra* note 225, at 250 ("the L3C statutory operating restrictions are designed as an *ipso facto* proxy for PRI status, but that fact-based determination has always resided with federal tax authorities.").

[238] *See* id. at 244 ("Few foundation managers will proceed without an advance ruling, and none will proceed without at least an opinion of counsel."). Bishop describes the tranche investing used by L3C—the private foundation tranche is higher risk-lower return while the commercial tranche is lower risk-higher return. He then suggests that tranche investing could lead to prohibited private inurement or private benefit because the private foundation may be creating private benefit for the investors in the commercial tranche. *See id.* at 263-65; *see also* Xia, *supra* note 225, at 251-53 (describing three tiers of investments).

[239] Galle, *supra* note 3, at 1198.

[240] For a discussion of fiduciary duties and mission-related investing, see Susan N. Gary, *Is It Prudent to be Responsible: The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 NW. J.L. & SOC. POL'Y 106 (2011).

foundation manager might worry about whether the investment might be a jeopardizing investment. To address this concern, in 2015 the Treasury issued Notice 2015-62.[241] The notice confirms that an investment made both to further the charity's mission and to produce financial returns is not a breach of fiduciary duties and is not a jeopardizing investment, even if the returns are below market.[242]

If a private foundation enters into a PRI, the investment is excluded from the investment assets on which the foundation's minimum distribution amount is computed, but an MRI is not so excluded. That is, the foundation will need to distribute an amount equal to 5 percent of the value of any MRIs. The Treasury Notice should give comfort to managers engaging in mission-investing, but the managers will still need to find enough revenue elsewhere to meet the distribution requirements. The difficulty of qualifying an investment as a PRI and the need for investments that generate sufficient revenue to meet the distribution requirements may keep some types of innovative investments off limits for a private foundation.

2. Grants to Solve Global Problems

As concern about global problems increases, private foundations may want to make grants directly to organizations in other countries that seek to address those problems. The U.S. tax code limits deductions for gifts to foreign entities and imposes restrictions on grants by private foundations to foreign charities.[243] For a private foundation, two of the private foundation rules affect distributions to foreign charities or for charitable activities conducted in a foreign country. Unless distributions meet the specific requirements of sections 4942 and 4945, distributions cannot be used to meet the minimum distribution requirement will be subject to an excise tax imposed on "taxable expenditures."

[241] Treas. Notice 2015–62, 2015–39 I.R.B. 411 (Sept. 28, 2015).

[242] *Id.* The Notice should not be used to protect a foundation manager that makes poor investment choices.

[243] For the history of the tax rules on transfers to foreign charities, see Nina Crimm, *Through a Post-September 11 Looking Glass: Assessing the Roles of Federal Tax Laws and Tax Policies Applicable to Global Philanthropy By Private Foundations and Their Donors*, 23 VA. TAX REV. 1, 16-24 (2003).

A private foundation contemplating a grant to a foreign charity supporting global activities must make the grant to a foreign organization that has a determination letter from the IRS that it would qualify as a public charity under U.S. law if it were a U.S. organization, make a determination that the foreign donee would qualify as a public charity, or exercise expenditure responsibility over the grant.[244] Few public charities have determination letters, and both the other options require extensive work on the part of the private foundation and the donee.[245]

If the private foundation wants to support a new organization working in a foreign country, expenditure responsibility may be required because there will not yet be sufficient information available to establish equivalency to a public charity. Exercising expenditure responsibility requires a great deal of cooperation and information from the donee, and a donee organization that is trying to get off the ground may lack the administrative infrastructure to manage the necessary record-keeping and reporting. Thus, making grants to newly formed foreign charities will be difficult at best.

3. Grants to Individuals

Venture philanthropists,[246] who are more likely to take risks than traditional philanthropists, may operate through private foundations. They may want to make grants to individuals and certain types of grants to individuals require a private foundation to obtain advance approval of the process by which the grant is made.[247] If a private foundation intends to make grants for scholarships, prizes, awards, or to make grants that will help recipients or produce a report or improve a literary, artistic, musical, scientific,

[244] Treas. Reg. § 53.4942(a)-3(c)(1). Crimm provides a thorough explanation of the expenditure responsibility rules. Crimm, *supra* note 243, at 39-59.
[245] Crimm, *supra* note 243, at 39-59.
[246] LaVerne Woods wrote about the emergence of venture philanthropy in 2001. LaVerne Woods, *The Emergence of 'Venture Philanthropy' Raises New Tax Issues*, 13 J. TAX'N EXEMPT ORGS. 51 (2001). She describes venture philanthropists as seeking ongoing involvement with their grantees and emphasizing capacity building for the grantees. Id. She cites Letts, Ryan and Grossman, *Virtuous Capital: What Foundations Can Learn From Venture Capitalists*, 75 HARV. BUS. REV. 36 (Mar/Apr 1997) for further discussion of the differences between venture philanthropy and traditional philanthropy.
[247] I.R.C. § 4945(d)(3). The grant-making process must be objective and nondiscriminatory.

teaching, or other skill, the IRS must approve the foundation's grant-making process in advance or the grant will be a taxable expenditure.[248]

The requirement of expenditure responsibility for certain types of grants encourages conservative grant-making.[249] Faced with expenditure responsibility, a foundation may choose to make grants to public charities and forego grants that would require greater administrative and legal costs. The result may be an inclination to maintain grant-making at the required minimum rather than expand beyond that minimum.

IV. Conclusions

A. Continue the Five Percent Distribution Percentage

1. Some Requirement Is Appropriate

A requirement to distribute a minimum amount seems appropriate for private foundations. The current experience with donor advised funds provides a cautionary reminder that donors may be tempted to warehouse charitable assets if the law does not require distributions. A donor to a donor-advised fund can get an income tax deduction in the year of the gift and then recommend[250] distributions from the fund in future years. Evidence has shown that some donors are using donor advised funds to warehouse charitable funds.[251] Donor-advised funds are considered public charities and therefore no

[248] I.R.C. § 4945(d)(3), (g).

[249] This concern was raised in response to the 1969 Act. *See* Labovitz, *supra* note 104, at 83-84. A comparison of data from 1967 with data from 1970 indicated that the expenditure responsibility rules may have reinforced a tendency to conservative grant making. Labovitz found, "Most foundations simply avoided expenditure responsibility grants…." *Id*. at 83. *See also* Crimm, *supra* note 3, at 1122 ("The TRA of 1969 also imposed restrictions on unorthodox or nontraditional grants, thereby having the potential effectively to paralyze significant innovation and inhibit progress in dealing with controversial problems, such as the urban crisis and race relations.").

[250] The fund controls the assets but typically will follow the donor's advice as to distributions, as long as the donees are approved charitable recipients.

[251] The GAO has identified the accumulation of assets in donor-advised funds as a public policy concern in a report to Congress. U.S. Gov't Accountability Office, *Tax-Law Enforcement: IRS Could Better Leverage Existing Data to Identify Abusive Schemes Involving Tax-Exempt Entities*, Report to the Committee on Finance, U.S. Senate (Sept. 2019), at 15 ("A DAF account that accumulates funds indefinitely, while legal, raises policy concerns about the lack of a requirement to distribute funds to charity.") Colinveaux and

minimum distribution requirement applies to them. The consequence has been that although some donors direct the distribution of their funds in excess of 5 percent each year, others do not. The temptation to build a larger and larger fund may appeal, or perhaps an individual donor may procrastinate and just not advise the fund holder to distribute. For whatever reason, the experience with donor advised funds suggests that a fund created by an individual donor may need a nudge to make appropriate distributions each year.

2. Five Percent Seems About Right

What then is an appropriate level for distributions? The 5 percent required distribution amount appears not to have caused the early demise of too many private foundations. Some foundations terminate, but that can happen for a number of reasons and may not be a bad thing, given that those charitable assets are now being used by other charities. Other foundations continue to grow, even with the 5 percent rule. Thus, it does not appear that requiring a 5 percent minimum distribution amount is unduly burdensome, especially given that the amount includes administration expenses, the tax on investment income, and any PRIs a foundation might have.[252] Increasing the required percentage could adversely affect the continued financial health of private foundations, so if the law wants to support perpetual foundations, an increase is unwise.

B. Donors Should be Permitted to Create Perpetual Foundations

1. State Law

State law requires charities to comply with donor intent. The trust law duty of obedience applies to trustees of charitable trusts, and an equivalent duty applies to

Madoff recommend delaying the income tax deduction until a gift is made from the fund to a charity. Colinveaux & Madoff, *supra* note 221.

[252] A donor concerned that the percentage is too high can consider a donor-advised fund or a social welfare organization as an alternative.

directors of charitable nonprofit corporations.[253] A fiduciary managing a charitable fund is expected to carry out any restrictions imposed by donors, including the direction that the fund be held in perpetuity. UPMIFA reflects these fiduciary duties, with its instructions to fiduciaries to consider "the duration and preservation" of a fund when making spending decisions.[254]

2. Public Benefits

Of course, the federal government could restrict a tax benefit without preventing a donor from establishing a perpetual foundation. For federal tax purposes, the question should be whether the public benefit of allowing a foundation to hold charitable assets indefinitely justifies an upfront income tax deduction for the donor. The answer, in my view, is that it does. Foundations have served and continue to provide valuable public benefits. They may provide some amount of private benefit to the donor or the donor's family, in terms of recognition and control, but other tax and state law rules limiting private inurement should adequately protect the charitable assets from donor abuse.[255] Donors may be more willing to direct their assets to charitable purposes if they can do so through a private foundation created to last in perpetuity.

C. Can Innovative Charitable Activities Be Encouraged?

Private foundations may want to engage in more impact investing than is currently feasible under the private foundation rules. PRIs are possible, but somewhat risky for the foundation managers. MRIs do not raise fiduciary or jeopardizing investment concerns, but the amount invested will not be excluded from the computation of the required distribution amount. A question is whether there is some way for a foundation to exclude

[253] RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGANIZATIONS (2019).

[254] UPMIFA § 4(a)(1).

[255] Egregious examples of abuse in the charitable sector exist, but many of the publicized examples involve public charities rather than private foundations. *See* Roger Colinvaux, *Charity in the 21st Century: Trending toward Decay*, 11 FLA. TAX REV. 1 (2011). And these examples must be balanced against the many charities that do good work without allowing private inurement to occur.

from the distribution requirement investments that are significantly but not primarily for mission. Perhaps some percentage of MRIs, such as 50 percent, could be excluded from investment assets. That idea is worth considering, as a way to encourage more mission-related investing, but I suspect the line-drawing will prove too difficult. A determination of a "significant" purpose for an investment that has both mission and financial purposes will be challenging.

Private foundations that want to engage in impact investing can do so using PRIs and should be more willing to do so. An impact investment can produce a financial return and still be a PRI as long as the primary purpose for the investment is the foundation's charitable purpose, so the rules as they exist provide opportunities. If more foundations engage in impact investing, perhaps the designation of the impact investments as PRIs will become more common.