CHAPTER ONE

Introduction to Private Foundations

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§ 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

p. 1, first line. ***Delete*** **millions of** ***and insert:***

over 1.5 million[1]

p. 1. ***Delete second paragraph.***

p. 2, note 1. ***Change footnote number to*** **1.1.**

§ 1.2 DEFINITION OF PRIVATE FOUNDATION

p. 5, note 10. ***Insert before period:***

; IRS Revenue Procedure (Rev. Proc.) 2020-5, 2020-1 I.R.B. 241, § 7.03

§ 1.7 OPERATING FOR CHARITABLE PURPOSES

p. 18, carryover paragraph, first line. ***Insert footnote following period:***

[88.1] Reg. § 1.501(c)(3)-1(c)(1).

[1] The IRS Data Book, 2018 (Pub. 55B) informs that there are, as of the federal government's fiscal year 2018, 1,327,714 recognized charitable and like organizations in the United States, plus 115,778 nonexempt charitable trusts and split-interest trusts and 216 apostolic entities. This number of charitable organizations does not include religious organizations that are not required to seek recognition of tax exemption or entities covered by a group exemption.

p. 18, carryover paragraph, sixth line. ***Delete*** **organizational** ***and insert*** **operational.**

p. 18, carryover paragraph. ***Delete fifth complete sentence, including footnote.***

p. 18, note 89. ***Delete text and insert:***

A private foundation has its tax-exempt status revoked for failing to engage in any exempt activities over a long period of time (Community Education Foundation v. Commissioner, 112 T.C.M. 637 (2016), appeal denied because of lack of representation (__ F.3d __ (D.C. Cir. 2018))).

p. 18, note 90. ***Delete text and insert:***

In general, Tax-Exempt Organizations § 4.4.

§ 1.9 PRIVATE FOUNDATION SANCTIONS

p. 24. ***Change heading to read:***

PRIVATE FOUNDATION LAW SANCTIONS

pp. 24–26. ***Delete text following heading on page 24 and through the first complete paragraph on page 26, and insert:***

The federal tax rules pertaining to private foundations[136] are often characterized in summaries as if they are typical laws, in the sense of prescriptions governing human behavior. This is not the case; these rules, comprising portions of the Internal Revenue Code, are tax provisions. Thus, this body of law states that, if a certain course of conduct is engaged in (or, perhaps, not engaged in), imposition of one or more excise taxes will be the (or a) result. For example, there is no rule of federal tax law that states that a private foundation may not engage in an act of self-dealing;[137] rather, the law is that an act of self-dealing will trigger one or more excise taxes and other sanctions.[138]

(a) Sanctions (a Reprise)

Because of the nature of this statutory tax law structure, a person subject to an excise tax does not merely pay it and continue with the transaction and its consequences, as is the case with nearly all federal tax regimes. This structure weaves a series of spiraling taxes from which the private foundation, and/or

[136] E.g., § 1.4(a)-(h).
[137] State law, however, may contain such a rule. E.g., Neb. Rev. Stat. § 21-1916.
[138] Even the IRS occasionally gets this wrong. For example, in a private letter ruling, the IRS stated that certain payments by a private foundation to disqualified persons "would be acts of self-dealing that are prohibited by Chapter 42 of the Internal Revenue Code" (Priv. Ltr. Rul. 201703003).

disqualified person(s) with respect to it, can emerge only by paying one or more taxes and correcting (undoing) the transaction involved by paying or distributing assets or having the foundation's income and assets confiscated by the IRS.

The private foundation rules collectively stand as sanctions created by Congress for the purpose of curbing what was perceived as a range of abuses being perpetrated through the use of private foundations by those who control or manipulate them. These provisions comprise Chapter 42 of the Internal Revenue Code. Some of these constraints were placed on supporting organizations and donor-advised funds in 2006.[139]

(b) Self-Dealing Sanctions as Pigouvian Taxes

In the self-dealing context, two excise taxes are imposed on self-dealers—the initial tax[140] and the additional tax.[141] The first tax has a rate of 10 percent; the second a rate of 200 percent. There are also taxes on foundation managers where there is knowing participation in the self-dealing transaction (a scienter requirement).[142] The foundation self-dealing tax subjects the entire amount involved in a self-dealing transaction to tax. Also, the initial self-dealing tax cannot be abated by the IRS.[143] There is the correction feature, by which the self-dealer is required to pay the amount involved to the foundation.[144]

What has come to be known as the *Pigouvian tax* is the brainchild of English economist Arthur Cecil Pigou (1879–1959), a contributor to modern welfare economics. He introduced the concept of *externality* and the belief that externality (social problems) can be corrected by imposition of a tax. A commentator wrote that Pigouvian taxes "aim to regulate behavior by placing a small tax, usually in the form of a uniform excise tax, on the activity to be regulated because of the harm it produces for members of the public."[145]

Does the federal self-dealing tax regime constitute one or more Pigouvian taxes? On the face of it, the answer would seem to be yes.[146] This commentator nicely observed that the self-dealing taxes "have the Pigouvian impulse to protect the public from harm by imposing an excise tax."[147] Despite this impulse, however, three reasons were posited why the self-dealing taxes are

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[139] See Chapters 15 and 16.

[140] IRC § 4941(a)(1).

[141] IRC § 4941(b)(1).

[142] IRC § 4941(a)(2), (b)(2).

[143] IRC § 4962(b).

[144] IRC § 4941(e)(3).

[145] Aprill, "The Private Foundation Excise Tax on Self-Dealing: Contours, Comparisons, and Character," 17 *Pitt. L. Rev.* 297 (Spring 2020).

[146] This is because of the inherent purpose of these taxes which is to regulate behavior, with the sanctions more in the nature of penalties than taxes (see § 1.9(c)).

[147] Aprill, *supra* note 145, at 329.

not Pigouvian in nature. One, the additional excise tax rate of 200 percent is not "small." Two, the initial tax subjects the entire amount involved in a self-dealing transaction to tax, "even if the transaction benefits the foundation," so that, in those circumstances, the requisite "social costs" are not involved.[148] Third, a Pigouvian tax assumes uniform social costs across all individuals and firms; the commentator mused whether "differences between large and small foundations, between corporate and family foundations, local and national foundations, old and new foundations, etc. should shape the applicable excise tax rules."[149]

Yet, it is understandable why one, perhaps not an economist, would conclude that the self-dealing taxes are Pigouvian in nature, if only because the initial tax cannot be abated and because of the correction requirement. The U.S. Supreme Court stated the general rule about a tax: "Imposition of a tax nonetheless leaves an individual with a lawful choice to do or not do a certain act, so long as he is willing to pay a tax levied on that choice."[150] The self-dealing tax regime does not allow for that type of "lawful choice."

(c) Self-Dealing Sanctions: Taxes or Penalties?

Federal constitutional law differentiates between a tax and a penalty—at least conceptually. This distinction may be drawn in determining whether the exaction passes constitutional muster. A dramatic illustration of this point occurred when a bare majority of the U.S. Supreme Court upheld the constitutionality of the Patient Protection and Affordable Care Act on the basis of Congress's taxing power, construing the health insurance individual mandate (or shared-responsibility payment) as a tax, after the decision was made that the mandate could not be justified as constitutional pursuant to the Commerce Clause.[151] On that occasion, however, the Court observed that "Congress's ability to use its taxing power to influence conduct is not without limits."[152]

In this opinion, the fact that there is a difference between a tax and a penalty was raised, but not resolved. The Court wrote that "there comes a time in the extension of the penalizing features of the so-called tax when it loses

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[148] *Id*. at ___.

[149] *Id*. at ___.

[150] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 574 (2012).

[151] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519 (2012). The Tax Clause is the subject of U.S. Constitution Article I § 8. For a detailed summary of this opinion, see Hopkins, *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (Hoboken, NJ: John Wiley & Sons, 2012) § 4.8.

[152] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 572 (2012).

its character as such and becomes a mere penalty with the characteristics of regulation and punishment."[153] Also, the Court stated that, "[i]n distinguishing penalties from taxes, this Court has explained that 'if the concept of penalty means anything, it means punishment for an unlawful act or omission.'"[154] The Court concluded, having decided that the individual mandate (or shared-responsibility payment) is a tax for constitutional law purposes, wrote that "we need not here decide the precise point at which an exaction becomes so punitive that the taxing power does not authorized it."[155] It should be remembered that, even if an exaction is determined to be a penalty, the constitutionality of the statutory structure may be upheld under the Commerce Clause.[156]

In the opinion, the Court principally relied on two of its precedents in discussing what is and is not a tax. In one of these cases, the Court wrote that a "federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed."[157] It was stated that a tax may have a "regulatory effect" but remains a tax if it "produces revenue."[158] The Court added: "It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical to the public welfare."[159] In the other of these cases, the Court concluded that an ostensible tax was a penalty, because the sanction imposed a heavy burden, included a scienter requirement, and was enforced by a federal agency other than the Department of the Treasury.[160]

The Supreme Court observed, in 1974, that the Court in its "early cases" drew what it saw at the time as distinctions between regulatory and

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[153] *Id*. at 573.

[154] *Id*. at 567, quoting United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 224 (1996).

[155] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 573 (2012). Earlier in its opinion, the Court majority held that the payment was not a tax for statutory law purposes.

[156] The shared-responsibility payment was reduced to zero, effective January 1, 2019, by enactment of the Tax Cuts and Jobs Act (Pub. L. No. 115-97, 131 Stat. 2054 (2017). A federal court held that the entirety of the Affordable Care Act, as modified by the TCJA, is unconstitutional because the individual mandate is now unconstitutional because it can no longer be justified as a tax and the mandate is inseverable from the Act's remaining provisions (Texas et al. v. United States, 336 F. Supp. 3d 664 (N.D. Tex. 2018)). An appellate court agreed with the district court as to the present-day unconstitutionality of the individual mandate but remanded the case for a more detailed analysis as to severability (Texas et al. v. United States). The U.S. Supreme Court, on January 21, 2020, declined to expedite its review of this case (U.S. House of Representatives v. Texas, No. 19-841; California et al. v. Texas, No. 19-840). The Fifth Circuit, on January 29, 2020, denied a request for a full-panel hearing of the case (Texas et al. v. United States, No. 19-10011).

[157] United States v. Kahriger, 345 U.S. 22, 28 (1953).

[158] *Id*.

[159] *Id*.

[160] Bailey v. Drexel Furniture, 259 U.S. 20 (1922).

revenue-raising taxes, adding "[b]ut the Court has subsequently abandoned such distinctions."[161] These "early cases" included six court decisions concerning the private foundation law sanctions.

Several court opinions focus on the constitutionality of the federal self-dealing law. In one of these cases, the principal contention was that the provision is an unconstitutional extension of the congressional taxing power.[162] That is, the allegation in that case was that the purpose of the statute is not to raise revenue but to regulate private foundations by imposing penalties on persons who use them for noncharitable, private purposes. The court involved rejected the contention, using five Supreme Court cases as precedent.

The court began its analysis by observing that, in its early decisions analyzing the constitutionality of tax statutes, the Supreme Court "often drew distinctions between regulatory and revenue raising taxes."[163] The court, however, wrote that the Court "has subsequently abandoned such distinctions."[164] The court quoted a 1937 Supreme Court opinion stating that "[i]t is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or definitely deters the activity taxed."[165] In that opinion, the Court wrote that this "principle applies even though the revenue obtained is obviously negligible"[166] "or the revenue purpose of tax may be secondary."[167]The Court also stated: "Nor does a tax statute necessarily fall because it touches on activities which Congress may not otherwise regulate."[168] The court concluded that, "[u]nder the present posture of the law, tax statutes are constitutional unless they contain provisions which are extraneous to any tax need."[169]

This court stated that "[i]t is clear that [the self-dealing statute] is constitutional as measured by the standards set forth in [the 1953 case]."[170] It continued: "Congress has seen fit, in enacting the internal revenue laws, to grant tax

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[161] Bob Jones University v. Simon, 416 U.S. 725, 791, note 12 (1974).

[162] Rockefeller v. United States, 572 F. Supp. 9 (E.D. Ark. 1982), *aff'd per curiam*, 718 F.2d 290 (8th Cir. 1983), *cert. den.*, 460 U.S. 962 (1984).

[163] 572 F. Supp. at 13, citing Hill v. Wallace, 259 U.S. 44 (1922); Bailey v. Drexel Furniture Co., 259 U.S. 20 (1922); and Helmig v. United States, 188 U.S. 605 (1903).

[164] Rockefeller v. United States, 572 F. Supp. 9, 13 (E.D. Ark. 1982), quoting United States v. Sanchez, 340 U.S. 42 (1950).

[165] United States v. Sanchez, 340 U.S. 42, 44-45 (1950), citing Sonzinsky v. United States, 300 U.S. 506, 513-514 (1937).

[166] United States v. Sanchez, 340 U.S. 42, 44 (1950), citing Sonzinsky v. United States, 300 U.S. 506, 513-514 (1937).

[167] United States v. Sanchez, 340 U.S. 42, 44 (1950), citing Hampton & Co. v. United States, 276 U.S. 394 (1928).

[168] United States v. Sanchez, 340 U.S. 42, 44 (1950).

[169] Rockefeller v. United States, 572 F. Supp. 9, 13 (E.D. Ark. 1982), citing United States v. Kahriger, 345 U.S. 22, 31 (1953).

[170] Rockefeller v. United States, 572 F. Supp. 9, 13 (E.D. Ark. 1982).

exempt status to certain entities" and "has allowed individuals, corporations, and estates the right to escape taxation of the amounts donated for charitable purposes."[171] "However," the court wrote, "when Congress observed that its legislative grace was being abused, it enacted [the self-dealing statute] to insure that its original intent in granting non-taxable status was complied with."[172] The court concluded that, "[a]lthough [the statute] has a regulatory effect on the activities of charitable organizations and might not raise any revenue, it insures that revenue will be collected under income, estate, and gift tax laws which otherwise might have gone uncollected."[173]

Another court case directly involving a private foundation regulatory provision in relation to the sanction's status as a tax is a challenge to the mandatory payout rule.[174] In that case as well, the argument was that, by enacting the provision, Congress exceeded its power to lay and collect excise taxes. The contention was that the provision does not impose a tax for constitutional law purposes but "imposes a penalty measured by a prescribed rate of return on the value of the foundation's noncharitable property even though the foundation may have no income."[175] The court rejoined that the Supreme Court "has repeatedly rejected this argument," citing the 1928, 1934, and 1937 cases, adding that the "tax in question is a legitimate exercise of the taxing power despite its collateral regulatory purpose and effect."[176]

This court wrote that, "[b]y enacting [the mandatory payout rule] . . . Congress decided to subject tax-exempt private foundations to [the rule that the tax must be paid even though the foundation has no income] in order to deal with what it perceived to be an abuse of the foundation's tax-exemption

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[171] *Id*.

[172] *Id*.

[173] *Id*. The court, in *Rockefeller*, decided that the first-tier self-dealing tax is a penalty for purposes of a rule concerning interest (IRC § 6601(3)). Likewise, Farrell v. United States, 484 F. Supp. 1097 (E.D. Ark. 1980); Deluxe Check Printers, Inc. v. United States, 14 Ct. Cl. 782 (1988), 15 Ct. Cl. 175 (1988), *rev'd on other issue*, 885 F.2d 848 (Fed. Cir. 1989).

Two federal appellate courts rejected the argument that the self-dealing taxes are excise levies and held that these sanctions are penal in nature (Mahon v. United States (In re Unified Control Systems, Inc.), 586 F.2d 1036 (5th Cir. 1978); United States v. Feinblatt (In re Kline), 547 F.2d 823 (4th Cir. 1977)).

Following a brief survey of some of this case law, in a case challenging the constitutionality of the self-dealing excise taxes, the U.S. Tax Court stated simply that it "find[s] no basis for holding any of the provisions of section 4941 unconstitutional (Estate of Reis v. Commissioner, 87 T.C. 1016, 1020 (1986)).

[174] Stanley O. Miller Charitable Fund v. Commissioner, 89 T.C. 1112 (1987). See Chapter 6.

[175] *Id*. at 1119.

[176] *Id*. at 1120. Other tax law arguments rejected in *Miller* are that the mandatory payment tax is a direct tax in violation of Art. 1, sec. 9; and that the tax violates the Sixteenth Amendment. Also rejected was the notion that this form of taxation involves denial of due process in violation of the Fifth Amendment.

privilege," in that "[w]hile donors to the exempt private foundation could receive substantial current tax benefits from their contributions, charity might receive no current benefits because the foundation invested in growth assets that produce no current income but are expected to increase in value."[177] Although the court did not expressly so state, private foundations in this circumstance are required to dip into principal to make the required distribution.[178]

The legislative history of the self-dealing rules is replete with references to the sanctions as penalties. The report of the House Committee on Ways and Means accompanying its version of the 1969 tax legislation states that the "permissible activities of private foundations . . . are substantially tightened to *prevent* self-dealing between the foundations and their substantial contributors."[179] The committee added that it "has determined to generally *prohibit* self-dealing transactions and provide a variety and graduation of sanctions."[180] In this report, there are numerous references to these sanctions as constituting "prohibitions" or arising out of "prohibited" conduct. Identical or similar language appears in the report of the Senate Committee on Finance in connection with its version of the 1969 legislation.[181] This continues to be the view of Congress on this topic, as reflected in a report issued by the Ways and Means Committee in 1996 referring to the private foundation rules as a "penalty regime."[182]

A commentator, following a review of the case law, wrote that the "character" of the self-dealing and similar private foundation provisions "as a tax or a penalty seems uncertain" under the Supreme Court opinion upholding the Affordable Care Act.[183] It is pointed out that the Court's most recent discussion of what constitutes a penalty "turns, at least in part, not on the purpose of or motive for an assessment, but on its level—whether it imposes a heavy burden."[184] Here are the features posed for such a "heavy burden" under the self-dealing sanctions regime: (1) the first-tier taxation of the entire amount of a self-dealing transaction, rather than just the amount by which the foundation is harmed; (2) the second-tier tax rate of 200 percent,

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[177] Stanley O. Miller Charitable Fund v. Commissioner, 89 T.C. 1112, 1122 (1987).
[178] See § 6.1.
[179] H. Rep. No. 91-413, 91st Cong., 1st Sess. (1969), Part I, at 4 (emphasis added).
[180] *Id.*, Part IV, at 21 (emphasis added).
[181] S. Rep. No. 91-552, 91st Cong., 1st. Sess. (1969).
[182] H. Rep. No. 104-506, 104th Cong., 2nd Sess. 56 (1996). This observation was made in the context of a discussion of the intermediate sanctions rules applicable with respect to public charities, social welfare organizations, and certain nonprofit insurance issuers (IRC § 4958), which in many ways are structured in the same fashion as the private foundation rules. In general, *Intermediate Sanctions*.
[183] Aprill, *supra* note 145, at 322.
[184] *Id.*

which "gives a disqualified person little if any meaningful choice of whether or not to pay the tax"; (3) the implication of the scienter requirement in connection with the excise taxes on foundation managers who knowingly participate in a self-dealing transaction; (4) the court opinions that view the self-dealing sanctions as having the "regulatory purpose [of] rendering self-dealing unlawful"; and (5) the IRS's inability to abate the first-tier excise tax.[185] A sixth indicator of penalty status in this context may be the correction requirement.

This commentator concludes that "private foundation excise taxes do not fit easily into either the category of constitutional taxes or constitutional penalties."[186] As to the self-dealing taxes, the commentator writes that the "status of section 4941 is uncertain under *NFIB*, under the private foundation cases from the 1980s, and the positions of key governmental bodies."[187] Nonetheless, a good case can be made, at least as to the self-dealing tax regime, that the sanctions amount to one or more penalties. The Pigouvian impulse tugs.

(d) Abatement

§ 1.10 STATISTICAL PROFILE

p. 28. ***Delete last two paragraphs and insert:***

According to the Foundation Center's data for 2015, the assets of private foundations in the United States totaled $860 billion and qualifying distributions totaled $62.8 billion.

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[185] *Id*.
[186] *Id*. at 323.
[187] *Id*. at 325.