CHAPTER ONE

Introduction to Private Foundations

Of the almost two million tax-exempt charitable organizations in the United States,[1] only about 90,000 of them are classified, for federal tax purposes, as private foundations.[2] The isolation of private foundations for purposes of government regulation makes private foundations unique.

1. The IRS Data Book, 2022 (Pub. 55-B) informs that there are, as of the federal government's fiscal year 2022 (ending September 30, 2022), nearly 2 million tax-exempt organizations in the United States, almost 1.5 million of which are recognized charitable and similar organizations (including private foundations), plus 108,654 nonexempt charitable trusts and split-interest trusts and 221 apostolic entities. This number of charitable organizations does not include religious organizations that are not required to seek recognition of tax exemption.
2. National Philanthropic Trust, "2022 Donor-Advised Fund Report" (Nov. 2022) 35.

§ 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

The federal tax law segregates private foundations from other charitable entities, these other entities being generically referred to as *public charities*. Congress legislated the difference between private foundations and public charities by means of the Tax Reform Act of 1969; in so doing, it triggered a chain of reactions and developments in the tax law that shows no sign of abating. In a move that made life more complicated for nearly all in the charitable community, the federal tax law presumes that all charitable organizations are private foundations. (The burden of proving non–private foundation status rests with each charitable organization; the process of rebutting the presumption is part of the procedure for filing for recognition of tax-exempt status.)[3]

Certainly, the regulatory regime imposed on private foundations is unique. There is no category of tax-exempt organization that is subject to anything like the compliance burdens that comprise the sweep of Chapter 42 of the Internal Revenue Code. Even the origin of this legislation is unique. The mood of Congress was very anti–private foundation during the course of its endeavors in this regard in the years leading up to the 1969 legislation, with the nation's legislature dismayed at the findings presented to it by the Department of the Treasury in a 1965 report and by a series of congressional hearings.[4] The animosity toward, sometimes hostility against, private foundations that motivated members of Congress and the staff at that time is reflected in the legislation that quickly took shape that year.

When Congress targeted privately funded charities and gave them special status, the following sections were added to the Internal Revenue Code. These sections have operational constraints that govern the conduct of private foundations and impose excise taxes for failures to adhere to the rules.

- IRC § 4940—Tax on Investment Income
- IRC § 4941—Taxes on Self-Dealing
- IRC § 4942—Taxes on Failure to Distribute Income
- IRC § 4943—Taxes on Excess Business Holdings
- IRC § 4944—Taxes on Investments That Jeopardize Charitable Purpose
- IRC § 4945—Taxes on Taxable Expenditures

3. Internal Revenue Code of 1986, as amended, section (IRC §) 508(b). The procedure for filing for recognition of tax-exempt status is the subject of § 2.7.
4. See § 1.3.

- IRC § 4946—Disqualified Persons
- IRC § 4947—Application of Taxes to Certain Nonexempt Trusts
- IRC § 4948—Foreign Private Foundations
- IRC § 507—Termination of Private Foundation Status

Sanctions for failure to comply with the private foundation rules potentially include a tax (called the *Chapter 42 taxes*) on both the foundation and its disqualified persons, loss of tax exemption, and repayment of all tax benefits accrued during the life of the foundation for its funders and itself. Under certain circumstances, these taxes can be abated if the violation was due to reasonable cause, rather than for willful and intentional reasons, and if the violation is properly corrected.[5]

Notwithstanding the turbulence within their legal setting, private foundations are a viable and valuable type of nonprofit organization. They are also unique in that they are often used to accomplish the personal philanthropic goals of individuals. Some professional advisors discourage the formation of private foundations because of the complexity of the regulatory rules underlying and surrounding them. There is no question that the foundation rules are often more complicated than those applicable to public charities and other forms of exempt organizations. The addition of the donor-advised fund rules and the reformation of the Type III supporting organization rules by the Pension Protection Act of 2006, however, has narrowed the differences between those two types of charitable entities and private foundations. Many operational constraints and procedural requirements formerly only applicable to private foundations now also apply to donor-advised funds[6] and Type III supporting organizations.[7] Nevertheless, the creation and operation of a private foundation can be a rewarding experience.

Private foundations are ideal charitable vehicles for many funders. An individual can create a foundation qualified for tax exemption and be its sole trustee or director, retaining absolute control. Commonly, a donor and their family members comprise the governing board of a private foundation, although financial and other transactions between them and the foundation are tightly constrained by the tax law.

Funders who wish to be flexible in their grant-making programs may prefer a private foundation for a similar reason. While an annual grant payout requirement must be adhered to, there is considerable latitude in the design of its charitable programs. The foundation can maintain its own programs

5. IRC § 4962. See § 12.4(c).
6. See § 16.7.
7. See § 15.6(g).

rather than fund others; this entity is the *private operating foundation*. Here, a funder can establish the foundation, hire a staff, and work to further their own charitable purposes.

Another potential advantage is the fact that family members or other disqualified persons can be paid reasonable compensation in the form of director or trustee fees for their services on the organization's governing board. These persons can also be paid salaries for services rendered in their capacity as staff members. Those who learn the rules and plan well to adhere to them need not allow the tax law excise taxes to serve as a deterrent to the creation of a private foundation.

Finally, a private foundation can serve as an ideal income and estate planning device for individuals with charitable interests. The classic example is a philanthropist who has publicly traded stock that is highly appreciated in value. A private foundation can be created, the securities contributed to the foundation and sold by that entity, and the philanthropist may claim a charitable contribution deduction based on the full fair market value of the stock and avoids taxation of the capital gain. The foundation can retain the stock and endeavor to expand its base of principal, and essentially spend only the income from its investments for its charitable purposes.

Philanthropists who make charitable bequests can create private foundations to receive a portion of the bequest while they are living. Contributions to the foundations made during the donor's lifetime are deductible, thereby increasing the estate by reducing income tax. The property gifted to the private foundation and the undistributed income accumulating in the private foundation are not subject to estate tax. A private foundation can also be the remainder interest beneficiary of a charitable remainder trust created during the donor's lifetime. This approach usually results in more after-tax money for the foundation and other beneficiaries.

This unique entity known as a private foundation is thus both heavily regulated by a body of extensive and complex law and a very useful charitable planning vehicle. To achieve the optimum in charitable giving and granting by means of a private foundation, the management and advisors to the foundation must master this body of law. The pages that follow are intended to be a guide to that end.

§ 1.2 DEFINITION OF PRIVATE FOUNDATION

Essential to an understanding of the special federal tax rules applicable to private foundations is the tax law definition of the term private foundation. The federal tax law defines the term *private foundation* as a domestic or foreign charitable organization, other than one of the four categories of entities

collectively known as *public charities*.[8] Thus, one way to view a private foundation is as a charitable organization[9] that does not qualify as a form of public charity.

Each U.S. and foreign charitable organization is presumed to be a private foundation; this presumption is rebutted by a showing that the entity is a church, school, hospital, medical research organization, agricultural research organization, publicly supported charity, supporting organization, or organization that tests for public safety.[10] That is, by operation of law, if a charitable organization cannot be classified as a public charity, it is (or becomes) a private foundation.[11]

Despite the absence of a generic definition of the term, a private foundation essentially is a tax-exempt organization that has these characteristics: (1) it is a charitable organization, (2) it is funded from one source (usually an individual, a family, or a business), (3) its ongoing revenue is derived from investments (in the nature of an endowment fund),[12] and (4) it makes grants to other charitable organizations rather than operating its own program (unless it is a private operating foundation).[13] Congress could have crafted an affirmative definition of the term *private foundation*, using these criteria, but the statutory scheme enacted in 1969 was, as noted, developed in a strenuously anti-private foundation environment and the "definition" was thus devised in a manner to make it as encompassing as possible. (Indeed, the statutory definition is actually one of what a private foundation *is not*, rather than a definition of what a private foundation *is*.)

If a charitable organization was a private foundation on October 9, 1969, or becomes a private foundation on any subsequent date, it will be treated as

8. IRC § 509(a); Reg. § 1.509(a)-1. The requirements to establish public charity status are the subject of Chapter 15.
9. That is, an organization that is tax-exempt pursuant to IRC § 501(a) as an organization described in IRC § 501(c)(3).
10. IRC § 509(a)(1)-(4).
11. IRC § 508(b); IRS Revenue Procedure (Rev. Proc.) 2023-5, 2023-1 I.R.B. 265 § 7.04(2). Even though these rules have been in existence for over 50 years, there still is confusion surrounding them. This phenomenon was reflected in a decision by a federal court of appeals, which twice misstated the law as to private foundations and public charities, first by incorrectly stating that "a tax-exempt organization is not automatically classified as a private foundation," and second by erroneously declaring that if "a section 501(c)(3) organization does not meet the distinct requirements provided by section 509(a), the organization is treated as public charity" (Stanbury Law Firm, P.A. v. Internal Revenue Service, 221 F.3d 1059 (8th Cir. 2000)).
12. While private foundations may receive a consistent flow of ongoing donations, most do not.
13. The *private* aspect of a private foundation, then, principally reflects the nature of its financial support as well as the nature of its governance.

a private foundation for all periods thereafter even though it may also qualify as some other type of tax-exempt organization, unless its private foundation status is terminated.[14] In other words, a charitable organization in existence on October 9, 1969, cannot hope to avoid private foundation status by claiming it also qualifies as, for example, a social welfare organization.[15] Likewise, if an organization created after October 9, 1969, obtains recognition from the IRS as a public charity, and later loses this status and becomes reclassified as a private foundation, it cannot claim non-private-foundation status thereafter by claiming status as a social welfare organization.

In contrast, a private foundation created after October 9, 1969, may apply and be recognized as a social welfare organization if it qualifies as such and did not previously seek recognition from the IRS as a charitable organization.[16] This is because charitable organizations created after October 9, 1969, are not considered "described in section 501(c)(3)" unless they notify the IRS and apply for recognition of exemption.[17] Thus, the presumption of private foundation status[18] is inapplicable to post-1969 organizations that do not apply for exemption;[19] such organizations likewise are not covered as organizations "described in section 501(c)(3)" in the definition of a private foundation.[20]

If an organization was a private foundation on October 9, 1969, and it is subsequently determined that it no longer qualifies as a charitable entity, it will continue to be treated as a private foundation (until it terminates such status).[21] In other words, an organization cannot shed its private foundation status by changing its governing instrument and operating as a taxable entity.

If circumstances change, or if its creators wish it, a private foundation can terminate its private foundation status. This happens most frequently where the organization's level or mix of funding is such that it can qualify as a publicly supported charity or where the organization converts to a supporting organization.[22] A private foundation may terminate its private foundation status by distributing all its assets to a public charity and dissolving itself or by merging into one or more other private foundations.[23]

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14. IRC § 509(b); Reg. § 1.509(b)-1(a). The private foundation termination rules are the subject of Chapter 13.
15. IRC § 501(c)(4).
16. E.g., Priv. Ltr. Rul. 200846041.
17. IRC § 508(a). Organizations created prior to October 9, 1969, are not subject to this notice and application requirement for exempt status (*id.*).
18. Under IRC § 508(b).
19. IRS General Counsel Memorandum (Gen. Couns. Mem.) 37485.
20. IRC § 509(a).
21. Reg. § 1.509(b)-1(b).
22. See § 13.4. As to the requirements to qualify as a publicly supported charity or supporting organization, see Chapter 15.
23. See Chapter 13.

§ 1.3 BACKGROUND

Private foundations have long been much-maligned entities, not only in the federal tax laws but within society at large. Their history, which is extensive, is rich with many successes and strewn with few abuses.[24] They are vehicles for some of the most humanitarian and progressive acts, yet whenever a list of tax reforms is compiled, private foundations, and/or the tax law rules that apply to them, always seem to attract much attention.

A private foundation is a unique breed of tax-exempt organization, in that while it is recognized as charitable, educational, or the like, it is usually controlled and supported by a single source, for example, one donor, a family, or a company. This one characteristic, which the Internal Revenue Service has recognized as an indirect but nonetheless qualifying means of support of charity,[25] has spawned several criticisms, including alleged irresponsive governance and inadequate responses to perceived needs. Private foundations are similarly chastised for being elitist, playthings of the wealthy, and havens for "do-gooders" assuaging their inner needs by dispensing beneficence to others.[26]

More serious criticisms of private foundations are that they further various tax inequities, are created for private rather than philanthropic purposes, and do not actually achieve charitable ends.[27] As will be developed in subsequent chapters, nearly all the abuses—apocryphal or otherwise—involving private foundations were eradicated as the result of the enactment of the Tax Reform Act of 1969.[28]

The origins of private foundations are traceable to the genesis of philanthropy. Foundations as legal entities were recognized in the Anglo-Saxon legal system and were fostered in the United States by the law of charitable trusts. Charitable endowments in America are essentially creatures of common law, although amply sustained in statutory laws concerning taxes, corporations, decedents' estates, trusts, and property.[29] The modern American foundation is of relatively recent vintage, dating back to the mid-nineteenth century. Many of

24. Wormser, *Foundations: Their Power and Influence* (Sevierville, TN: Catholic House Books, 1993); Andrews, *Philanthropic Foundations* (New York: Russell Sage Foundation, 1956).
25. IRS Revenue Ruling (Rev. Rul.) 67-149, 1967-1 C.B. 133.
26. E.g., Branch, "The Case Against Foundations," *Washington Monthly* 3 (July 1971).
27. E.g., Stern, *The Great Treasury Raid* (New York: Random House, 1964), 242–246. *Cf.* Stern, *The Rape of the Taxpayer* (New York: Random House, 1973).
28. As one court stated, Congress enacted these rules "to put an end, as far as it reasonably could, to the abuses and potential abuses associated with private foundations." (Mannheimer Charitable Trust, Hans S. v. Commissioner, 93 T.C. 35, 39 (1989)).
29. Fremont-Smith, *Foundations and Government, State and Federal Law* (New York: Russell Sage Foundation, 1965), especially Chapter 1.

the well-known foundations are reflective of the great fortunes established at the advent of the 1900s. Foundations proliferated after World War II, in large part because of favorable economic conditions and tax incentives. More recently, private foundations founded and funded by those successful in the realm of technology are being added to the list of the nation's largest charities.

Private foundations were not defined in the Internal Revenue Code (nor in any other federal statute) until 1969—though not because of Congress's lack of interest in them. They were investigated, for example, by the "Walsh Committee" (the Senate Industrial Relations Committee) from 1913 to 1915 for allegedly large stockholdings, by the "Cox Committee" (House Select Committee to Investigate and Study Educational and Philanthropic Foundations) in 1952, by Representative B. Carroll Reece in 1954 (the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations) for alleged support of subversives, and by Representative Wright Patman throughout the 1960s for allegedly tending more to private interests than public benefit.

Prior to enactment of the Tax Reform Act of 1969, a private foundation generally was recognized as a charitable organization to which contributions could be made that were deductible in an amount up to 20 percent of an individual donor's adjusted gross income, in contrast to contributions to churches, schools, hospitals, and other public charities, which were deductible to the extent of 30 percent of the individual donor's adjusted gross income.[30]

This 30 percent/20 percent dichotomy was introduced in the federal tax law in 1954, when Congress acted in recognition of the fact that there are distinctive differences among charitable organizations. In that year, Congress permitted an extra 10 percent deduction (from 20 percent to 30 percent) for contributions to churches, educational institutions, and hospitals, and enacted other provisions in their favor. In 1964, the privileged class of 30 percent organizations was expanded to include other public and publicly supported organizations, and a five-year carryover of excess contributions was added for gifts to these organizations.

By the mid-1960s, the likelihood that alleged private foundation abuses would eventually result in statutory modifications was on the increase. A *Treasury Report on Private Foundations*, issued in 1965,[31] emphasized the view that there was a need for more public involvement in the operation of philanthropic institutions that benefit from preferential treatment under the tax laws. Failing direct public involvement, this report stated that there should be an assurance through other means (namely, governmental regulation) that funds set aside for

30. IRC § 170(b)(1) (pre-1969 Act).
31. Treasury Department Report on Private Foundations, Committee on Finance, United States Senate, 89th Cong., 1st Sess. (1965).

appropriate charitable purposes will find their way promptly into the hands of those institutions where there is assurance of public control and operation.

Congress, having become convinced that there were problems concerning charitable organizations that needed remedy, believed that these problems were especially prevalent in the case of organizations in the 20 percent deduction category. On the other hand, it was also apparent that most organizations in the 30 percent deduction group were not implicated in these problems.

Congressman Patman's and others' inquiries culminated in the extensive foundation provisions of the Tax Reform Act of 1969,[32] which introduced the first statutory definition of the term *private foundation*. Yet a more expressive definition is: ". . .a nongovernmental, nonprofit organization, with funds and program managed by its own trustees or directors, and established to maintain or aid social, educational, charitable, religious, or other activities serving the common welfare."[33]

Controversy persists over the appropriate role for foundations in America—or whether they should exist at all. Foundations are attacked by some as too uninvolved in current issues and problems and by others as too effective in fomenting social change. The federal government is now spending billions of dollars in the realms of health, education, and welfare, formerly the domain of private philanthropy. Recent years have also borne witness to intensified drives for tax reform, tax equality, and tax simplification. These and other developments have made the tax treatment for private foundations and their donors even more vulnerable.

Notwithstanding a variety of anti-foundation developments in the regulatory context, Congress and the executive branch of the federal government have, on occasion, affirmed their support for private foundations. For example, the Department of the Treasury had this to say about the value of foundations:

> Private philanthropy plays a special vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.

32. Andrews, *Patman and Foundations: Review and Assessment* (New York: Foundation Center, 1968); Myers, "Foundations and Tax Legislation," VI *Bull. of Found. Lib. Center* (No. 3) 51 (1965). Following a preliminary survey in 1961, Rep. Patman caused publication of "Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy," Chairman's Report to (House) Select Committee on Small Business, First Installment, 87th Cong., 1st Sess. (1962). Six additional installments were published over the period 1963 to 1968.
33. The Foundation Center, *The Foundation Directory*, 4th ed. (1971), vii.

> Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity.[34]

Private foundations are an integral component of a society that values individual responsibility and private efforts for the public good. One organization championing private foundations advances the following rationale:

> Foundations have the particular characteristic of serving as sources of available capital for the private philanthropic service sector of our society in all its range and variety. They thus help make possible many useful public services that would in most cases otherwise have to be provided by tax monies. They offer "the other door on which to knock," without which many volunteer activities would not be initiated and others could not be continued. They are there to respond both to new ideas and [to] shifting social needs with a freedom and flexibility that is not common to or easy for government agencies. Finally, as centers of independent thought and judgment in their own right, they help support freedom of thought, experimentation, and honest criticism directed at pressing needs of the society, including even the scrutiny and evaluation of governmental programs and policies.[35]

The great regulatory surge that swept over private foundations has largely subsided as the regulators have moved on to focus on other types of nonprofit organizations. The federal tax laws applicable to foundations remain complex, but, for the most part, the foundation community has learned to coexist with them. Nonetheless, it must be conceded that, as the U.S. Tax Court observed (and subsequent chapters indicate), "classification as a private foundation is burdensome."[36]

§ 1.4 PRIVATE FOUNDATION TAX LAW PRIMER

Private foundations are a type of charitable organization, exempt from federal income tax. As such, they are subject to the rules applicable to charitable

34. Treasury Department Report on Private Foundations, Committee on Finance, United States Senate, 89th Cong., 1st Sess. (1965), 5 (also 12-13).
35. Council on Foundations, Report and Recommendations to the Commission on Private Philanthropy and Public Needs on Private Philanthropic Foundations (1974), 1–8.
36. Friends of the Society of Servants of God v. Commissioner, 75 T.C. 209, 212 (1980).

organizations generally. In addition, private foundations are subject to detailed and stringent rules.

(a) Introduction

The federal tax law pertaining to private foundations was enacted as part of the Tax Reform Act of 1969.[37] The ensuing years have not brought much substantive change in the overall statutory framework. These years, however, have brought many pages of tax regulations, hundreds of private letter rulings, and a considerable number of court opinions.

Private foundation statutory law has inspired similar rules for public charities, most notably the intermediate sanctions rules,[38] some of the supporting organizations rules,[39] and the donor-advised fund rules.[40] Recently, Congress has grafted some of the private foundation rules onto the public charity rules, such as application of the excess business holdings[41] rules to donor-advised funds[42] and application of these rules to supporting organizations.[43]

(b) General Operational Requirements

Private foundations must apply for recognition of tax-exempt status;[44] must file annual information returns with the IRS;[45] must meet a special organizational test;[46] must satisfy certain disclosure requirements;[47] may receive deductible charitable contributions (albeit usually within more stringent limitations than public charities);[48] must adhere to the general rules imposed on tax-exempt charities, such as the general organizational test, the operational test, the private inurement doctrine, the private benefit doctrine, the limitation on legislative activities, and the prohibition on political campaign activities;[49] must comply with a battery of unique laws, where the sanctions include imposition of one or more excise taxes (most of which are subject to abatement

37. IRC Chapter 42 (IRC §§ 4940–4948).
38. IRC § 4958. See *Tax-Exempt Organizations*, Chapter 21.
39. See § 15.6.
40. See § 16.7.
41. See Chapter 7.
42. See § 16.7.
43. See § 15.6(k).
44. See § 2.7.
45. See § 12.1(a).
46. See § 1.7.
47. See § 12.3.
48. See Chapter 14.
49. See *Tax-Exempt Organizations* §§ 4.3, 4.5, and Chapters 20, 22, and 23, respectively.

provisions);[50] must pay an excise tax on net investment income;[51] and must comply with the unrelated business rules.[52]

(c) Disqualified Persons

A variety of persons are considered disqualified persons with respect to a private foundation. These persons are generally equivalent to insiders in connection with the private inurement doctrine.[53]

Disqualified persons with respect to private foundations are (1) substantial contributors, that is, the creator of the foundation if it is a charitable trust or a person that has contributed more than $5,000 to the foundation where the gift amount is in excess of 2 percent of the donee's total support during its existence as measured at the time of the contribution; (2) foundation managers, that is, a foundation trustee, director, officer, or an individual with similar powers or responsibilities; (3) an owner of more than 20 percent of a business where the entity is a substantial contributor; (4) a member of the family of an individual referenced in the foregoing three categories; (5) a corporation, partnership, trust, or estate in which any of the persons referenced in the foregoing four categories have more than a 35 percent ownership or other interest; (6) another private foundation (but only for purposes of the excess business holdings rules); and (7) a government official (but only for purposes of the self-dealing rules).[54]

(d) Self-Dealing Rules

The self-dealing rules essentially prohibit, by means of excise taxes and a correction requirement, financial transactions between a private foundation and a disqualified person.[55]

Generally, self-dealing transactions are (1) sales, exchanges, or leasing of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) payment of compensation, or payment or reimbursement of expenses, by a private foundation to a disqualified person; and (5) payment by a private foundation to a governmental official (with exceptions).[56]

50. See § 12.4(c).
51. See Chapter 10.
52. See Chapter 11.
53. See *Tax-Exempt Organizations* § 20.3.
54. See Chapter 4.
55. See Chapter 5.
56. See § 5.3.

There are exceptions to these general rules, including (1) payment of compensation by a private foundation to a disqualified person for certain personal services, where the compensation is reasonable and is in furtherance of the foundation's exempt purposes; (2) certain lending and furnishing arrangements without interest or other charge, when done in furtherance of charitable purposes; and (3) certain transactions occurring during the administration of a decedent's estate.[57]

These rules are underlain by a series of excise taxes, beginning with an initial tax on an act of self-dealing equal to 10 percent of the amount involved. Another excise tax is imposed on a foundation manager equal to 5 percent of the amount involved, subject to a $20,000 per act maximum tax. If the act of self-dealing is not corrected, an additional tax may be imposed on (1) a self-dealer equal to 200 percent of the amount involved; and (2) a foundation manager equal to 50 percent of the amount involved (subject to a $20,000 per act maximum tax). Where more than one self-dealer or foundation manager is liable for the tax with respect to any one act of self-dealing, the tax liability is joint and several. Abatement of the initial tax on self-dealing is not available, although the tax will not apply to a foundation manager whose participation in the act of self-dealing is not willful and is due to reasonable cause.[58]

(e) Mandatory Payout Rules

The private foundation mandatory payout rules are designed to cause foundations to spend currently rather than indefinitely accumulate income and assets.[59]

A private foundation is generally required to pay out for charitable purposes an amount equal to 5 percent of its noncharitable assets; this involves the concepts of minimum investment return and distributable amount. The amount distributed must be in the form of a qualifying distribution, which can involve a set-aside.[60]

An initial tax is imposed on a private foundation equal to 30 percent of undistributed income. An additional tax may be imposed on a foundation equal to 100 percent of undistributed income. There is a correction requirement.[61] Tax abatement is potentially available.[62]

57. See § 5.4-5.6, 5.12.
58. See § 5.15(a).
59. See Chapter 6.
60. See § 6.4.
61. See § 6.5.
62. See § 12.4(c).

(f) Excess Business Holdings Rules

The excess business holdings rules are designed to prevent the control of a for-profit business by a private foundation, alone or in conjunction with its disqualified persons.[63]

A private foundation is generally prohibited, by application of excise taxes, from having excess business holdings, which generally means more than a 20 percent interest in a business; where control of the business is elsewhere, the threshold amount is 35 percent. The holdings of disqualified persons are taken into account in calculating these percentages; a 2 percent de minimis rule considers only the foundation's holdings.[64]

An initial tax on a private foundation's excess business holdings is imposed, equal to 10 percent of the value of the holdings. An additional tax may be imposed equal to 200 percent of the value of excess business holdings. There is a correction requirement. Tax abatement is potentially available.[65]

(g) Jeopardizing Investments Rules

The jeopardizing investments rules imposed on private foundations can be viewed as a federal tax law codification of traditional prudent investment principles. These rules parallel state laws under which the managers of a private foundation have a fiduciary responsibility to safeguard its assets on behalf of its charitable constituents.[66]

A private foundation is subject to an excise tax if it invests an amount in a manner that would jeopardize the carrying out of an exempt purpose. There is no per se type of jeopardizing investment. An investment jeopardizes exempt purposes of a private foundation where its foundation managers failed to exercise ordinary business care and prudence, at the time the investment was made, in providing for the short-term and long-term financial needs of the foundation in connection with the conduct of its charitable programs.[67]

These rules are inapplicable to program-related investments, the primary purpose of which is to achieve charitable objectives and no significant purpose of which is the production of income or appreciation in the value of property.[68]

An initial tax is imposed on a private foundation in the amount of 10 percent of the jeopardizing investment. An initial tax is imposed on foundation managers in the amount of 10 percent of the investment, when they

63. See Chapter 7.
64. See § 7.2.
65. See § 12.4(c).
66. See Chapter 8.
67. See § 8.1.
68. See § 8.3.

knowingly participated in it, subject to a $10,000 per investment maximum tax. An additional tax in the amount of 25 percent may be imposed on a private foundation. There is an additional tax on foundation managers, subject to a $20,000 per investment maximum tax. There is a correction requirement.[69] Tax abatement is potentially available.[70]

(h) Taxable Expenditures Rules

The taxable expenditures rules place limitations on the types of grants private foundations are permitted to make.[71]

A private foundation makes a taxable expenditure if it pays or incurs an amount to carry on propaganda or otherwise attempts to influence legislation. These rules may be triggered if a foundation makes a grant to a public charity that attempts to influence legislation or if the foundation makes the expenditure directly. A private foundation may, however, engage in nonpartisan analysis, study, or research, as well as make expenditures that are protected by the self-defense exception.[72]

A private foundation makes a taxable expenditure if it pays or incurs an amount to influence the outcome of a public election, although the funding of certain voter registration drives is permitted.[73] A foundation makes a taxable expenditure if it makes certain types of grants to individuals without first seeking IRS approval.[74] A foundation makes a taxable expenditure when it makes a grant, loan, or a program-related investment, for charitable purposes, to an entity other than a public charity (or a Type III nonfunctionally integrated supporting organization), unless it exercises expenditure responsibility.[75] A foundation makes a taxable expenditure if it pays or incurs an amount for a noncharitable purpose.[76] Special rules apply in connection with grants to foreign charities.[77]

An initial excise tax of 20 percent is imposed on a private foundation's taxable expenditure. An initial tax of 5 percent is imposed on a foundation manager who agreed to the making of the expenditure, absent reasonable cause, subject to a per-expenditure maximum tax of $10,000. An additional tax may be imposed on a private foundation at the rate of 100 percent. An additional

69. See § 8.5.
70. See § 12.4(c).
71. See Chapter 9.
72. See § 9.1.
73. See § 9.2.
74. See § 9.3.
75. See §§ 9.4, 9.7.
76. See § 9.8.
77. See § 9.6.

tax may be imposed on a foundation manager at the rate of 50 percent, subject to a per-expenditure maximum tax of $20,000. There is a correction requirement.[78] Tax abatement is potentially available.[79]

(i) Tax on Investment Income

Generally, a private foundation is required to pay an excise tax of 1.39 percent on its net investment income.[80] This tax is not imposed on exempt operating foundations.[81]

(j) Termination of Private Foundation Status

Termination rules apply to private foundations, designed to prevent a foundation from ceasing to be a charitable organization so that it can use its funds and assets for noncharitable purposes.[82]

A private foundation's status may be voluntarily terminated by transfer of all of its income and assets to one or more public charities or if the foundation becomes a public charity.[83] A foundation's status may be involuntarily terminated if it engages in willful, flagrant, or repeated acts (or failures to act) giving rise to one or more of the private foundation excise taxes; a foundation in this circumstance would be liable for a termination tax.[84]

Special rules apply when a private foundation transfers assets to another private foundation pursuant to a liquidation, merger, redemption, recapitalization, or other adjustment.[85]

(k) Charitable Giving Rules

Generally, contributions to private foundations give rise to a federal income tax charitable contribution deduction.[86]

There are percentage limitations on the deductibility, for federal income tax purposes, of gifts by individuals to charitable organizations. These limitations are more stringent for gifts to private nonoperating foundations than is the case with respect to gifts to public charities: (1) 30 percent of adjusted gross income in instances of gifts of cash (as contrasted with 60 percent for

78. See 9.9.
79. See § 12.4(c).
80. See Chapter 10.
81. See § 10.7.
82. See Chapter 13.
83. See §§ 13.3, 13.4.
84. See §§ 13.2, 13.7.
85. See § 13.5.
86. See Chapter 14.

such gifts to public charities) and (2) 20 percent of adjusted gross income in instances of gifts of property (as contrasted with 30 percent for such gifts to public charities).[87]

Generally, a contribution of property that has appreciated in value to a charitable organization gives rise to a charitable deduction based on the property's fair market value. This type of gift to a private foundation, however, generally is deductible only to the extent of the donor's basis in the property, although there is an exception for gifts of qualified appreciated securities.[88]

Gifts to private foundations are subject to the general rules for all charitable gifts as to recordkeeping, substantiation, appraisal, disclosure, and reporting requirements.[89] These gifts also qualify for the gift and estate tax charitable deductions.[90]

(l) Unrelated Business Rules

Private foundations are subject to the unrelated business income tax rules.[91] Because of the excess business holdings rules, however, private foundations are limited in their ability to directly conduct an unrelated trade or business or to invest in pass-through entities that conduct unrelated businesses.[92] The excess business holdings rules exclude from the definition of business enterprise any activity that derives at least 95 percent of its gross income from passive sources, such as interest, dividends, royalties, rent, and capital gains.[93] This exclusion ties in with the modifications (exceptions) applicable in the unrelated business context.[94]

§ 1.5 DEFINITION OF CHARITY

A private foundation must be operated for charitable purposes. For the most part, this means that a foundation must confine its grant-making and other programs to charitable ends. One of the many responsibilities, then, of private foundation management is to be certain that each of the foundation's grantees, or its programs, qualify under one or more rationales for being charitable.

The federal tax law definition of the term *charitable* is based on English common law and trust law precepts. Federal income tax regulations recognize

87. See § 14.2(a).
88. See §§ 14.3-14.5.
89. See § 14.7.
90. See § 14.2(b).
91. See Chapter 11.
92. See Chapter 7.
93. See § 7.1(b).
94. See § 11.2.

this fact by stating that the term is used in its "generally accepted legal sense."[95] At the same time, court decisions continue to expand the concept of *charity* by introducing additional (more contemporary) applications of the term. As one court observed, evolutions in the definition of the word *charitable* are "wrought by changes in moral and ethical precepts generally held, or by changes in relative values assigned to different and sometimes competing and even conflicting interests of society."[96]

The term *charitable* in the federal income tax setting, in the more technical sense, embraces a variety of purposes and activities. These include relief of the poor and distressed or of the underprivileged, the advancement of religion, advancement of education, advancement of science, lessening of the burdens of government, community beautification and maintenance, promotion of health, promotion of social welfare, promotion of environmental conservancy, advancement of patriotism, care of orphans, maintenance of public confidence in the legal system, facilitating student and cultural exchanges, and promotion and advancement of amateur sports.[97]

Charitable organizations, as that term is used in the most encompassing manner, includes *educational* organizations. In addition to institutions such as schools, colleges, universities, museums, and libraries, educational organizations are those that (1) provide instruction or training of individuals in a variety of subjects for the purpose of improving or developing their capabilities or (2) instruct the public on subjects useful to the individual and beneficial to the community.[98]

Religious organizations are part of the community of charitable organizations. These entities are churches and other membership and non-membership religious organizations. For reasons of constitutional law, the terms *religion* and *religious* cannot be accorded a definition applied by governmental agencies.[99]

Scientific organizations are, for the most part, those that engage in scientific research. Entities that are scientific in nature may have as their primary purpose the dissemination of scientific information by such means as publications and conferences. These organizations may also be considered educational in nature.[100]

There are many additional types of tax-exempt organizations other than those that are charitable in nature. Other exempt organizations (often ones that private foundations will encounter) include title-holding corporations,[101]

95. Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).
96. Green v. Connelly, 330 F. Supp. 1150, 1159 (D.D.C. 1971), *aff'd sub nom*. Coit v. Green, 404 U.S. 997 (1971).
97. Reg. § 1.501(c)(3)-1(d)(2). See *Tax-Exempt Organizations*, Chapter 7.
98. Reg. § 1.501(c)(3)-1(d)(3). See *Tax-Exempt Organizations*, Chapter 8.
99. See *Tax-Exempt Organizations*, Chapter 10.
100. Reg. § 1.501(c)(3)-1(d)(5). See *Tax-Exempt Organizations*, Chapter 9.
101. That is, entities described in IRC § 501(c)(2) and (25). See *Tax-Exempt Organizations* § 19.2.

social welfare organizations,[102] labor organizations,[103] business and professional associations,[104] social clubs,[105] fraternal organizations,[106] veterans' organizations,[107] and political organizations.[108]

§ 1.6 OPERATING FOR CHARITABLE PURPOSES

A private foundation, as is the case with all tax-exempt charitable organizations, must meet a standard for qualification as a charitable organization, referred to as the *operational test*.[109] This test requires that the private foundation operate *exclusively* to accomplish one or more of the purposes referenced in the Internal Revenue Code: religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.[110] The term *exclusively* for purposes of the operational test does not literally mean exclusively, but rather means *primarily*.[111] Consequently, the conduct of some amount of nonexempt activity, such as unrelated business activity, is permitted for organizations qualifying for tax exemption as charitable organizations.

The operational test also provides that an organization is not operated exclusively for exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.[112] Simply stated, a private foundation may not operate to accomplish the private purposes or serve the private interests of its founders, those who control it, those who fund it, or their families—these persons are termed *disqualified persons*.[113]

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102. That is, entities described in IRC § 501(c)(4). See *Tax-Exempt Organizations*, Chapter 13.
103. That is, entities described in IRC § 501(c)(5). See *Tax-Exempt Organizations* § 16.1.
104. That is, entities described in IRC § 501(c)(6). See *Tax-Exempt Organizations*, Chapter 14.
105. That is, entities described in IRC § 501(c)(7). See *Tax-Exempt Organizations*, Chapter 15.
106. That is, entities described in IRC § 501(c)(8) and (10). See *Tax-Exempt Organizations* § 19.4.
107. That is, organizations described in IRC § 501(c)(19). See *Tax-Exempt Organizations* § 19.11.
108. That is, organizations described in IRC § 527. See *Tax-Exempt Organizations*, Chapter 17.
109. Reg. § 1.501(c)(3)-1(c)(1). A private foundation had 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 dismissed due to lack of representation by legal counsel).
110. IRC § 501(c)(3). An expenditure for the purpose of testing for public safety is not considered a charitable purpose under the taxable expenditure rules; therefore, a private foundation, unlike a public charity, is effectively precluded from being operated to accomplish this purpose by the taxable expenditure rules (see § 9.8).
111. Reg. § 1.501(c)(3)-1(c)(1); see *Tax-Exempt Organizations* § 4.4.
112. Reg. § 1.501(c)(3)-1(c)(2).
113. See Chapter 4. A strange and troublesome opinion from the U.S. Tax Court was based on the operational test. On that occasion, the court held that an organization cannot

A qualifying private foundation promotes the general welfare of society. Evidence for satisfaction of this operational test is found not only in the nature of the foundation's activities but also in its sources of financial support, the constituency for whom it operates, and the nature of its expenditures. The presence of a single nonexempt program, if substantial in nature, will destroy the exemption regardless of the number or importance of the truly exempt purposes.[114]

The benefit to an individual participating in a foundation's programs is acceptable when the activity itself is considered a charitable pursuit. Examples of these benefits are the advancement a student receives from attending college and the relief from suffering experienced by a sick person. The standards of permissible individual benefit are different for certain of the eight categories of charitable purpose, and the distinctions are sometimes vague and not necessarily logical. For example, promoting amateur sports competition is treated as an exempt purpose, but maintaining an athletic facility that restricts its availability to less than the entire community is not charitable.[115] A sports club serving only its individual members is not charitable,[116] but a fitness center promoting health and available to the general public may qualify as a charitable organization.[117] Visiting a museum or attending a play is recognized as educational, but attending a semiprofessional baseball game is not.[118]

To prove that its programs benefit the public, rather than private individuals, a private foundation often must be found to benefit an indefinite class of persons—a charitable class—rather than a particular individual or a limited group of individuals. It may not be "organized or operated for the benefit of private interests such as designated individuals, the creator's family, shareholders of the organization or persons controlled, directly or indirectly, by

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qualify for tax-exempt status as a charitable or educational entity because its activities and those of its founder, sole director, and officer are essentially identical (Salvation Navy, Inc. v. Commissioner, 84 T.C.M. 506 (2002)). The court wrote that the affairs of the organization and this individual are "irretrievably intertwined," so that the "benefits" of tax exemption would "inure" to the individual personally (*id*. at 508). Many charities engage in activities that their founders would otherwise personally undertake, and they are under the direct control of these individuals; this is typical of a private foundation.

114. Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 284 (1945).
115. Rev. Rul. 67-325, 1967-2 C.B. 113.
116. I Media Sports League, Inc. v. Commissioner, 52 T.C.M. 1092 (1986).
117. E.g., IRS Private Letter Ruling (Priv. Ltr. Rul.) 8935061. An important issue in these private rulings is whether fees charged limit the availability of the facility to the general public—a characteristic required to prove that the organization operates for charitable purposes.
118. Hutchinson Baseball Enterprises, Inc. v. Commissioner, 73 T.C. 144 (1979), *aff'd*, 696 F.2d 757 (10th Cir. 1982); Wayne Baseball, Inc. v. Commissioner, 78 T.C.M. 437 (1999).

such private interests."[119] Thus, a trust established to benefit an impoverished retired minister and his wife cannot qualify.[120] Likewise, a fund established to raise money to finance a medical operation, rebuild a house destroyed by fire, or provide food for a particular person does not benefit a charitable class. An organization formed by merchants to relocate homeless persons from a downtown area was found to serve the merchant class and promote their interests, rather than those of the homeless or the citizens.[121] In explaining the meaning of the word *charitable*, the regulations also deem federal, state, and local governments to be charitable entities by stipulating that relieving their burdens is a form of charitable activity qualifying for tax exemption.[122]

A charitable organization may benefit a comparatively small group of individuals if the group is not limited to identifiable individuals. The class need not be indigent, poor, or distressed.[123] A scholarship fund for a college fraternity that provided school tuition for deserving members was ruled to be a tax-exempt foundation,[124] but a trust formed to aid destitute or disabled members of a particular college class was deemed to benefit a limited class. The "general law of charity recognizes that a narrowly defined class of beneficiaries will not cause a charitable trust to fail unless the trust's purposes are personal, private, or selfish as to lack the element of public usefulness."[125] Criteria for selection of eligible beneficiaries should be followed, and evidence used to choose eligible individuals—case histories, grade reports, financial information, recommendations from specialists, and the like—should be maintained.

A genealogical society tracing the migrations to and within the United States of persons with a common name was found to qualify as a tax-exempt social club, rather than a charity. Although there was educational merit in the historical information compiled, the private interest of the family group was held to predominate.[126] If membership in the society is open to all and its focus is educational—presenting lectures, sponsoring exhibitions, publishing a

119. Reg. § 1.501(c)(3)-1(d)(1)(iii).
120. Carrie A. Maxwell Trust, Pasadena Methodist Foundation v. Commissioner, 2 T.C.M. 905 (1943).
121. Westward Ho v. Commissioner, 63 T.C.M. 2617 (1992).
122. Reg. § 1.501(c)(3)-1(d)(2); see *Tax-Exempt Organizations* § 7.7 for a discussion of standards for qualifying as "lessening the burdens of government."
123. Consumer Credit Counseling Service of Alabama, Inc. v. United States, 78-2 U.S.T.C. ¶ 9468 (D.C.1979), but See El Paso del Aquila Elderly v. Commissioner, 64 T.C.M. 376 (1992) (making burial insurance available at cost for the elderly is a charitable activity only if distress is relieved, by allowing indigents to participate, and the community as a whole benefits).
124. Rev. Rul. 56-403, 1956-2 C.B. 307.
125. Gen. Couns. Mem. 39876.
126. Callaway Family Association, Inc. v. Commissioner, 71 T.C. 340 (1978); Rev. Rul. 67-8, 1967-1 C.B. 142.

geographic area's pioneer history—it may be classified as charitable.[127] In contrast, a society limiting its membership to one family and compiling research data for family members individually cannot qualify for tax exemption.[128]

§ 1.7 ORGANIZATIONAL RULES

One of the fundamental requirements in the law pertaining to tax-exempt organizations, particularly charitable ones, is that these organizations must be *organized* for one or more tax-exempt purposes. This is known as the *organizational test*.[129]

The organizational test for charitable organizations, in general, emphasizes two requirements. One focuses on the organization's statement of purposes, requiring language that articulates a charitable end and forbidding language that may empower the organization to engage, to more than an insubstantial extent, in noncharitable activities or to pursue noncharitable purposes.[130] The other mandates a *dissolution clause*, which directs the passage of the organization's assets and net income, in the event of its dissolution or liquidation, for charitable ends, usually by causing transfer of the assets and income to one or more other charitable organizations.[131]

There is, however, a separate and additional organizational test for private foundations. A private foundation cannot be exempt from federal income tax (nor will contributions to it be deductible as charitable gifts) unless its governing instrument or the provisions of state law applicable to it include provisions, the effects of which are to require distributions at such time and in such manner as to comply with the annual payout rules and prohibit the foundation from engaging in any act of self-dealing, retaining any excess business holdings, making any jeopardizing investments, or making any taxable expenditures.[132] Generally, these provisions must be in the foundation's articles of organization[133] and not merely in its bylaws.[134]

The provisions of the governing instrument of a private foundation or applicable state law must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation managers or other disqualified persons with respect to the foundation, will

127. Rev. Rul. 80-301, 1980-2 C.B. 180.
128. Rev. Rul. 80-302, 1980-2 C.B. 182.
129. Reg. § 1.501(c)(3)-1(b).
130. Reg. § 1.501(c)(3)-1(b)(1).
131. Reg. § 1.501(c)(3)-1(b)(2).
132. IRC § 508(e)(1); Reg. § 1.508-3(a). See Chapters 5–9.
133. See § 2.3.
134. Reg. § 1.508-3(c).

not be liable for any of the private foundation excise taxes.[135] The governing instrument of a nonexempt split-interest trust[136] must contain comparable provisions with respect to any of the applicable private foundation excise taxes.[137]

Specific reference in the governing instrument to the appropriate sections of the Internal Revenue Code is generally required, unless equivalent language is used that is deemed by the IRS to have the same full force and effect. A governing instrument that contains only language sufficient to satisfy the requirements of the organizational test for charitable organizations in general, however, does not meet the specific requirements applicable with respect to private foundations, regardless of the interpretation placed on the language as a matter of law by a state court.[138] A governing instrument of a private foundation does not meet these organizational requirements if it expressly prohibits the distribution of capital or corpus.[139]

A private foundation's governing instrument is deemed to conform with the requisite organizational requirements if valid provisions of state law have been enacted that require the foundation to act or refrain from acting so as not to subject it to any of the private foundation excise taxes or that treat the required provisions as being contained in the foundation's governing instrument.[140] The IRS ruled as to which state statutes contain sufficient provisions in this regard.[141]

Any provision of state law is presumed to be valid as enacted and, in the absence of state law provisions to the contrary, applies with respect to any private foundation that does not specifically disclaim coverage under state law (either by notification to the appropriate state official or by commencement of judicial proceedings).[142] If a state law provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the state involved or by the U.S. Supreme Court, the foundations covered by the determination must meet the private foundation organizational requirements within one year from the date on which the time for perfecting an application for review by the Supreme Court expires. If this application

135. Reg. § 1.508-3(b)(1). Rev. Rul. 70-270, 1970-1 C.B. 135, contains sample governing instrument provisions.
136. See § 3.7.
137. Reg. § 1.508-3(b)(1). Rev. Rul. 74-368, 1974-2 C.B. 390, contains sample governing instrument provisions.
138. Reg. § 1.508-3(b)(1).
139. Reg. § 1.508-3(b). In one instance, a charitable testamentary trust was found to have violated the private foundation organizational rules because the trust instrument required the trust to accumulate, rather than distribute, income; a state court ordered modification of the instrument to provide for the requisite distribution of the foundation's income (Estate of Barnes, 74-1 U.S.T.C. ¶ 9241 (Court of Common Pleas of Lancaster County, Pa. (1973)).
140. Reg. § 1.508-3(d)(1).
141. Rev. Rul. 75-38, 1975-1 C.B. 161.
142. Reg. § 1.508-3(d)(2)(i).

is filed, these requirements must be met within one year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision on the merits.[143] If a provision of state law is declared invalid or inapplicable with respect to a class of foundations by a court of competent jurisdiction, and the decision is not reviewed by the highest state appellate court or the Supreme Court, and the IRS notifies the general public that the provision has been declared invalid or inapplicable, then all private foundations in the state involved must meet these organizational requirements, without reliance on the statute to the extent declared invalid or inapplicable by the decision, within one year from the date the notice is made public.[144] These rules do not apply to a foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to the foundation.[145]

In one case, a charitable trust created by will in 1967 had its trust instrument amended by court order to enable the trust, a private foundation, to comply with the organizational requirements.[146] In a similar case, the trustees of a private foundation were permitted by a state court to modify a trust document to facilitate compliance by the foundation with these organizational rules.[147]

§ 1.8 PRIVATE FOUNDATION LAW SANCTIONS

The federal tax rules pertaining to private foundations 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;[148] rather, the law is that an act of self-dealing will trigger one or more excise taxes and other sanctions.[149]

143. Reg. § 1.508-3(d)(2)(ii).
144. Reg. § 1.508-3(d)(2)(iii).
145. Reg. § 1.508-3(d)(2)(iv).
146. Matter of Jeanne E. Barkey, 71-1 U.S.T.C. ¶ 9350 (Surrogate Court of New York County, N.Y. (1971)).
147. William Wikoff Smith trust estate, "The W. W. Smith Foundation," 72-1 U.S.T.C. ¶ 9271 (Court of Common Pleas Montgomery County, Orphans' Court Div., Pa. (1971)).
148. State law, however, may contain such a rule. E.g., Neb. Rev. Stat. § 21-1916.
149. 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).

(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 disqualified persons with respect to it, can emerge only by paying one or more excise taxes and correcting (undoing) the transaction involved, or all of the foundation's income and assets to the IRS in the form of a termination tax.[150]

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 private foundations by those who control or manipulate them. These provisions comprise a substantial part of Chapter 42 of the Internal Revenue Code.

(b) Self-Dealing Sanctions as Pigouvian Taxes

In the self-dealing context, two excise taxes are imposed on self-dealers—the initial tax[151] and the additional tax.[152] 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).[153] 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.[154] And there is a correction feature, by which the self-dealer is required to pay back the amount involved to the foundation.[155]

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."[156]

150. See § 13.7.
151. IRC § 4941(a)(1).
152. IRC § 4941(b)(1).
153. IRC § 4941(a)(2), (b)(2).
154. IRC § 4962(b).
155. IRC § 4941(e)(3).
156. Aprill, "The Private Foundation Excise Tax on Self-Dealing: Contours, Comparisons, and Character," 17 *Pitt. L. Rev*. 297 (Spring 2020) ("Aprill Article").

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.[157] This commentator nicely observed that the self-dealing taxes "have the Pigouvian impulse to protect the public from harm by imposing an excise tax."[158] Despite this impulse, however, three reasons were posited why the self-dealing taxes are 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.[159] 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."[160]

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."[161]

(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 (the "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.[162] On that occasion, however, the Court observed that "Congress's ability to use its taxing power to influence conduct is not without limits."[163]

157. 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 § 1.8(c)).
158. Aprill Article at 329.
159. *Id*. at 328.
160. *Id*.
161. National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 574 (2012).
162. *Id*. The Taxing Clause is the subject of U.S. Constitution Article I § 8. For a detailed summary of this opinion, see *Constitutional Law* § 4.8.
163. National Federation of Independent Businesses, *supra* note 161 at 572.

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 its character as such and becomes a mere penalty with the characteristics of regulation and punishment."[164] 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.'"[165] 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 authorize it."[166] 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.[167]

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, decided in 1953, the Court wrote that a "federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed."[168] It was stated that a tax may have a "regulatory effect" but remains a tax if it "produces revenue."[169] 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."[170] 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.[171]

164. *Id*. at 573.
165. *Id*. at 567, quoting United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 224 (1996).
166. National Federation of Independent Businesses, *supra* note 161 at 573 (2012). Earlier in its opinion, the Court majority held that the payment was not a tax for statutory law purposes.
167. 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 it can no longer be justified as a tax and the mandate is inseverable from the Act's remaining provisions (Texas 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 (*id*.). The U.S. Supreme Court ended this litigation by holding that the plaintiffs lacked standing (California v. Texas, No. 19-840).
168. United States v. Kahriger, 345 U.S. 22, 28 (1953).
169. *Id*.
170. *Id*.
171. Bailey v. Drexel Furniture, 259 U.S. 20 (1922).

In 1974, the Supreme Court observed that the Court in some of its early cases "drew what it saw at the time as distinctions between regulatory and revenue-raising taxes," adding "[b]ut the Court has subsequently abandoned such distinctions."[172]

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.[173] 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.

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."[174] The court, however, wrote that the Court "has subsequently abandoned such distinctions."[175] 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."[176] In that opinion, the Court wrote that this "principle applies even though the revenue obtained is obviously negligible"[177] "or the revenue purpose of tax may be secondary."[178] The Court also stated: "Nor does a tax statute necessarily fall because it touches on activities which Congress may not otherwise regulate."[179] 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."[180]

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]."[181] It continued: "Congress has seen fit, in enacting the internal revenue laws, to grant tax exempt status to certain entities" and "has allowed individuals, corporations, and estates the right to escape taxation of the amounts donated for charitable

172. Bob Jones University v. Simon, 416 U.S. 725, 791, n.12 (1974).
173. 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).
174. *Id*. 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).
175. Rockefeller, *supra* note 173 at 13, quoting United States v. Sanchez, 340 U.S. 42 (1950).
176. United States v. Sanchez, 340 U.S. 42, 44–45 (1950), citing Sonzinsky v. United States, 300 U.S. 506, 513–514 (1937).
177. *Id*. at 44.
178. *Id*., citing Hampton & Co. v. United States, 276 U.S. 394 (1928).
179. *Id*.
180. Rockefeller, *supra* note 173 at 13, citing Kahriger, *supra* note 168.
181. *Id*.

purposes."[182] "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."[183] 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."[184]

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.[185] 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."[186] The court rejoined that the Supreme Court "has repeatedly rejected this argument," and found that a tax may be "a legitimate exercise of the taxing power" notwithstanding that it has a "collateral regulatory purpose and effect."[187]

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 privilege,"

182. *Id*.
183. *Id*.
184. *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). But see Latterman v. United States, 872 F.2d 564 (3d 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)).
185. Stanley O. Miller Charitable Fund v. Commissioner, 89 T.C. 1112 (1987). See Chapter 6.
186. *Id*. at 1119.
187. *Id*. at 1120, citing the discussion in Sanchez, *supra* note 175, at 44–45, of the Court's decisions in Sonzinsky, *supra* note 176, Hampton, *supra* note 178, and Magnano Co. v. Hamilton, 292 U.S. 40, 47 (1934). The court also rejected the taxpayer's other arguments that the mandatory payment tax is a direct tax in violation of Art. 1, sec. 9; that the tax violates the Sixteenth Amendment; and that this form of taxation involves denial of due process in violation of the Fifth Amendment (inasmuch as a private foundation is given the choice to forfeit its tax-exempt status and thereby avoid having to make mandatory payouts).

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."[188] Although the court did not expressly so state, private foundations in this circumstance are required to dip into principal to make the required distribution.

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."[189] The committee added that it "has determined to generally *prohibit* self-dealing transactions and provide a variety and graduation of sanctions."[190] 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.[191] 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."[192]

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.[193] 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."[194] Here are the features posed for such a "heavy burden" under the self-dealing regime: (1) the imposition of the first-tier level of taxation on 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, which "gives a disqualified person little if any meaningful choice of whether or not to pay

188. Stanley O. Miller Charitable Fund v. Commissioner, 89 T.C. 1112, 1122 (1987).
189. H.R. Rep. No. 91-413, pt.1, at 4 (1969) (emphasis added).
190. *Id.*, Part IV, at 21 (emphasis added).
191. S. Rep. No. 91-552 (1969).
192. H.R. Rep. No. 104-506, at 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, *Tax-Exempt Organizations*, Chapter 21.
193. Aprill Article at 322; see National Federation of Independent Businesses, *supra* note 161.
194. Aprill Article at 322.

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 rules as having the "regulatory purpose [of] rendering self-dealing unlawful"; and (5) the IRS's inability to abate the first-tier excise tax.[195] 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."[196] As to the self-dealing taxes, the commentator writes that the "status of section 4941 is uncertain under [the Supreme Court opinion upholding the Affordable Care Act], under the private foundation cases from the 1980s, and the positions of key governmental bodies."[197] 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

The private foundation excise tax provisions themselves do not contain an exception, or excuse, for imposition of the taxes on a private foundation for failure to comply with the specific provisions. The regulations accompanying these provisions, however, contain relief for those foundation managers who do not condone or participate in the decision to conduct a prohibited action. Until 1984, the excise tax provisions were strictly applied.[198] Congress in 1984 added statutes[199] to permit abatement of the taxes imposed on both the foundation and its managers if it is established to the satisfaction of the IRS that the taxable event was due to reasonable cause and not to willful neglect, and the event was corrected within the applicable correction period. Abatement, however, is not available with respect to the initial tax on acts of self-dealing.[200]

(e) Potential of Overlapping Taxes

Taxes under more than one provision of the private foundation excise tax regime[201] may be imposed with respect to a single transaction.[202] Indeed, a

195. *Id*.
196. *Id*. at 323.
197. *Id*. at 325.
198. Charles Stewart Mott Foundation v. United States, 91-2 U.S.T.C. ¶ 50,340 (6th Cir. 1991); Mannheimer Charitable Trust, Hans S. v. Commissioner, 93 T.C. 35 (1989).
199. IRC §§ 4961-4963; see § 12.4(c).
200. IRC § 4962(b).
201. IRC Chapter 42 (IRC §§ 4940-4948).
202. Rev. Rul. 77-161, 1977-1 C.B. 358 ("A given set of facts can give rise to taxes under more than one provision of chapter 42 of the Code").

tax regulation states that "[i]t is not intended that the taxes imposed under Chapter 42 be exclusive."[203] For example, if a private foundation purchases a sole proprietorship in a business enterprise,[204] in addition to becoming subject to the excess business holdings tax,[205] the foundation may be liable for the jeopardizing investment tax[206] if the investment jeopardizes the carrying out of any of the foundation's exempt purposes.[207]

As an illustration of the potential for overlapping private foundation excise taxes, the IRS ruled, in a case involving private foundation loans to a disqualified person, that the loans were acts of self-dealing,[208] then added that they were also jeopardizing investments.[209]

(f) Influence on Subsequent Law

When enacted in 1969, the private foundation rules were unique. The statutory scheme devised by Congress had no precedent in the tax law. (The only other prior occasion when Congress levied a tax on otherwise tax-exempt organizations was on adoption of the tax on unrelated business income, implemented in 1950).[210] But in the immediate aftermath of enactment of the foundation rules, speculation started as to whether and to what extent this new approach might be extended to other tax-exempt organizations, principally public charities.

Since then, Congress has proved adept at extending some of the private foundation law to other types of tax-exempt charitable entities. For example, aspects of the excess business holdings rules were subsequently extended to certain supporting organizations[211] and to donor-advised funds.[212] The private foundation self-dealing rules heavily influenced the shaping of the excess benefit transaction rules.[213] Indeed, the very concept of underlying regulatory rules with a system of excise taxes, initiated with Chapter 42, is reflected in the excess benefit transaction rules,[214] public charity lobbying rules,[215] public

203. Reg. § 53.4944-1(a)(2)(iv).
204. See § 7.2(b).
205. See § 7.7.
206. See § 8.5.
207. Reg. § 53.4944-1(a)(2)(iv). See § 8.1(a).
208. See § 5.5.
209. Priv. Ltr. Rul. 201326019. See § 8.1(a) (as to jeopardizing investments).
210. See Chapter 11.
211. See § 7.5, 15.6(k).
212. See § 7.6, 16.7.
213. IRC § 4958. See *Tax-Exempt Organizations,* Chapter 21.
214. *Id*.
215. *Id*., Chapter 22.

charity political campaign activities rules,[216] and the donor-advised fund statutory law.[217]

Thus, private foundations law set in motion the use of a tax scheme that has been utilized since and undoubtedly will be used again. But the amount of interpretative law built up around these statutory rules is most extensive with respect to private foundations.

§ 1.9 STATISTICAL PROFILE

There are about 90,000 private foundations in the United States, thus accounting for a small percentage of tax-exempt charitable organizations in the sector. As of 2017, foundations held over $1 trillion in assets or about 1 percent of the net worth in the United States overall. Yet, on the basis of data for 2018, it is estimated that all nonprofit organizations had a collective net worth of $6.7 trillion; therefore, private foundations account for over one-seventh of assets held in the nonprofit sector.[218]

§ 1.10 PRIVATE FOUNDATIONS AND LAW 50 YEARS LATER

Notwithstanding the passage of more than 50 years, the statutory tax law regulating private foundations that was enacted in 1969—the infamous IRC Chapter 42—has not changed much. There have, of course, been some revisions, but the basic framework remains in place. There are several reasons for this phenomenon, one of them being the excellent craftsmanship that was employed when the initial statutory regime was formulated. This body of law is tough and comprehensive, although, five decades later, it is probably unnecessarily rigid and inequitable in places.

Parallel to the endurance of this statutory scheme has been the steady growth of the private foundation community. Today, there are, as noted, about 90,000 private foundations; all of the metrics reflect steady expansion: the sheer numbers of them, asset size, grant amounts, and the like. Foundations have persisted, notwithstanding this heavy mantle of statutory excise taxes (that essentially amount to prohibitions or affirmative requirements).[219]

216. *Id.*, Chapter 23.
217. See § 16.7.
218. These data are collected in Steuerle and Soskis, "Taxes and Foundations: A 50th Anniversary Overview," published by the Tax Policy Center, Urban Institute, and Brookings Institution (Feb. 8, 2020) (Steuerle & Soskis Paper). A subsequent report stated that there are nearly 2 million tax-exempt organizations in the United States (IRS Data Book, 2022 (Pub. 55-B) at 30).
219. See § 1.8. Two commentators nicely portrayed the Act as a "regulatory fusillade" on private foundations (Steuerle & Soskis Paper at 21).

This endurance and growth were not anticipated in all quarters in the immediate aftermath of enactment of the Tax Reform Act of 1969.[220] A chronicler of this 50-year period[221] collected some predictions issued in those early years. In one, two commentators characterized the effect of the Act as Congress having "thrown out the charitable baby with the dirty bathwater," "encouraging the abandonment" of private foundations, "interfering with their effective operation, attacking their involvement in major social problems and prohibiting what are in essence equitable transactions."[222] In another, the forecast was that "[a]ll of the odds seem stacked against" the growth of foundations, "given the range of disincentives built into the law."[223] Yet, private foundations have proved resilient and remain a major force in contemporary philanthropy.[224]

There have, however, been two generally unanticipated consequences of enactment of Chapter 42. Since 1969, Congress has adapted the rules enacted to reform the conduct of private foundations to apply to other types of tax-exempt charitable entities.[225]

The other unanticipated consequence of enactment of the private foundation tax laws is the rise of alternative entities. The most notable aspect of this development has been, and continues to be, the prodigious rise of the donor-advised fund.[226] For a variety of reasons, donor-advised funds often are used in lieu of private foundations, including the absence of a need to create and sustain a governing board, apply for recognition of exempt status, file annual information returns, and be subject to the mandatory payout rules, not to mention the lack of sufficient financial resources to warrant the formation and operation of a private foundation.[227]

The other primary alternative to the private foundation is the tax-exempt social welfare organization.[228] In this context, the concept of *social welfare* is commensurate with the "common good and general welfare" and "civic betterments and social improvements."[229] This concept is certainly broader than

220. See § 1.3.
221. Orol, "The Failures and the Future of Private Foundation Governance," 46 *ACTEC L. Jour*. (No. 2) 185 (Spring 2021) (Orol Article).
222. Goldstein and Sharpe, "Private Charitable Foundations After Tax Reform," 56 *A.B.A.J.* 447, 452 (May 1970).
223. Wadsworth, "Private Foundations and the Tax Reform Act of 1969," 39 *Law & Contemp. Probs*. 255, 262 (1975).
224. As one observer stated the matter, the "overwhelming consensus is that foundations have thrived in spite of, and not because of, the Tax Reform Act" (Orol Article at 210).
225. See, e.g., § 1.8(f).
226. See Chapter 16.
227. See § 2.1 and Chapter 16; *Tax-Exempt Organizations* § 11.8; *Charitable Giving* § 21.4.
228. This type of entity is exempt from tax under IRC § 501(a) as an organization that is described in IRC § 501(c)(4). See *Tax-Exempt Organizations,* Chapter 13.
229. Reg. § 1.501(c)(4)-1(a)(2)(i).

the concept of what is *charitable*.[230] A federal income tax charitable contribution deduction is not likely to be available in instances of transfers to social welfare organizations but donors may nonetheless make gifts to these entities, including gifts of appreciated property,[231] and avail themselves of the exclusion of such gifts from the federal gift tax.[232] These entities are not required to file for recognition of exemption,[233] may engage in political campaign activities, and are not subject to private foundation laws concerning self-dealing,[234] mandatory payouts, excess business holdings limitations, and the like. Donors, it is said, "are flocking to 501(c)(4) organizations."[235]

The previously referenced chronicler asserts that the "large number of existing private foundations and the significant value of their holdings mask a deep-seated and growing frustration with the restrictions imposed by the [Tax Reform] Act that threatens to dethrone the private foundation from its historical primacy in the field of private philanthropy."[236] It is contended that the combination of various issues in play, discussed below, has "precipitate[d] the decline of private foundations in favor of substantially—and arguably, troubling—less restrictive alternatives, which are largely structured in ways that make it less likely that they will achieve the type of broad-ranging social benefit that private foundations have historically fostered."[237]

This analysis concluded that there is a "lack of public confidence in the regulatory regime" applicable to private foundations.[238] Five reasons are given for this development: (1) The "single most significant source of the rules' negative consequences is their undue complexity," which (ostensibly) leads to "an explosion in administrative costs" due to legal fees;[239] (2) the dramatic decrease in IRS guidance in the private foundation field;[240] (3) many of the private foundation laws are bright-line rules that, while easier to administer, lead to over-inclusiveness in the form of unnecessary and often unfair penalties;[241]

230. See § 1.6.
231. See § 14.3.
232. A transfer of money or other property to tax-exempt organizations described in IRC § 501(c)(4), (5), or (6), for the use of such organizations, is not treated as a transfer by gift for purposes of the federal gift tax (IRC § 2501(a)(6)). See *Charitable Giving* § 6.2(g).
233. These organizations are, however, required to timely file a notice with the IRS (IRC § 506(a); see *Tax-Exempt Organizations* § 26.13).
234. These organizations are, however, subject to the excess benefit transactions law (IRC § 4958(e)).
235. Orol Article at 229.
236. *Id*. at 186.
237. *Id*. at 187.
238. *Id*. at 213.
239. *Id*. at 213-215.
240. *Id*. at 215-216.
241. *Id*. at 216-219.

(4) Congress and the public remain skeptical of private foundations, in part because of ongoing "undercurrents of anxiety about wealth," foundations' "control over charitable priorities," some well-publicized abuses, and (sometimes) lack of efficacy of the foundation laws;[242] and (5) the previously discussed rise in alternatives to private foundations.[243]

This chronicler is of the view that what is needed is a "clean slate for foundation governance,"[244] that is, foundation regulation. This is because the rules are "hopelessly complicated and penalize behavior that is not only not harmful but may in fact be beneficial for philanthropy."[245] In this regard, particular focus is placed on the self-dealing rules. Your authors are of the view that such a "clean slate" is unlikely for the foreseeable future and that, while the self-dealing and other foundation rules are indeed complex, the state of affairs is not so dire as to be "hopeless." The foundation community appears to have largely learned to accommodate the rules, advised by far more lawyers who are proficient in private foundation law than was the case many years ago. There is, however, room for more flexibility and equity in the private foundation self-dealing rules, and the IRS should be accorded authority to abate the self-dealing taxes.

This analysis raises the matter of the private foundation net investment income excise tax. As is well known, this tax was originally touted as an "audit fee," the purpose of which was to fund IRS oversight of private foundations and other components of the charitable sector—an outcome that never materialized. (It has never been clear as to why this earmarking of funds has never occurred.)[246] The analysis calls for reinstatement of this tax as an audit fee, with that law change unleashing a "cascade of benefits," including removal of bright-line rules in the self-dealing law and enabling foundations to "engage in certain behavior that is now penalized but would ultimately be beneficial charitable causes."[247] Of course, an alternative is to repeal the tax, perhaps freeing up more funds for charitable purposes. In any event, the attitude in

242. *Id*. at 219-225.
243. *Id*. at 225-230.
244. *Id*. at 230.
245. *Id*.
246. Two commentators dismiss this "audit fee" rationale as a mere "excuse," asserting that the true purpose of this tax is an "attack . . . on institutions thought to be controlled by the wealthy or benefiting an elite" (Steuerle & Soskis Paper at 27). The same may be said for the excise tax on college and university endowments (IRC § 4968; *Tax-Exempt Organizations* § 11.9(b)). One analysis states that, absent the audit-fee rationale, "it is difficult to justify the tax at all" (Orol Article at 233).
247. Orol Article at 234.

Congress about funding the IRS is shifting; the agency may soon have additional billions of dollars to spend on examinations and other forms of tax law enforcement.

Another area that is said to need improvement is IRS enforcement of the private foundation rules. It is common knowledge that the IRS is presently lacking in resources in this regard. The nation, however, appears to be entering an era of higher income taxes, increased funding of the IRS, and greater focus on audits of wealthy individuals. There is a correlation between this point and the prior one: "A more robust and well-resourced [IRS] audit function would allow us to move away from the bright-line rules that have proven to be overbroad and exceedingly complex."[248] One approach, as the chronicler noted, would be to return to the original concept of earmarking the funds generated by the tax on private foundations' net income for audits of foundations (and perhaps other categories of tax-exempt organizations).

This review of 50 years of experience with the private foundation tax laws observed that Congress "has the opportunity to retool the private foundation regulatory regime to ensure that private foundations maintain their place of primacy in private philanthropy and continue to deliver [their] socially-beneficial results."[249] Such a revision of this regulatory regime, however, is certainly not imminent. Indeed, the trend appears to be to leave the private foundation laws as they are and extend them to other exempt entities or create new forms of comparable regulation (such as in the case of donor-advised funds).

248. *Id*. at 230.
249. *Id*. at 237.