

# The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings

by Thomas A. Troyer

*Thomas Troyer is a partner with Caplin & Drysdale, Washington. He worked at Treasury in the mid-1960s as the private foundation law developed. He presented this paper October 28 at a roundtable sponsored by the New York University School of Law's National Center on Philanthropy and the Law.*

## I. Introduction

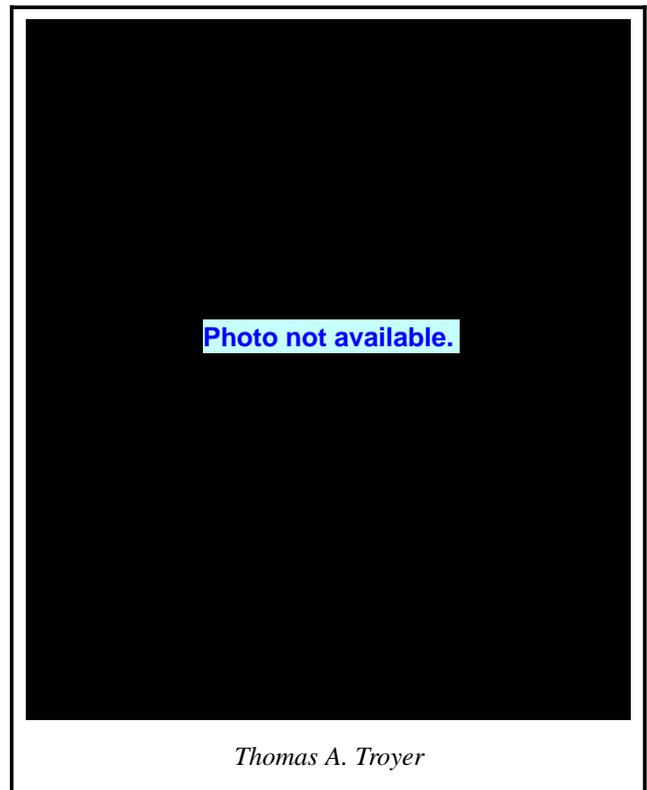
As the enactment of the 1969 private foundation legislation drifts into the past and those directly involved in the event largely disappear from the scene or fall silent, mythology — far from absent even in 1969 — often squeezes out fact. To some of those who think back to it, the legislation seems an aberrant spasm of Congressional anger at foundations, generated by the unfortunate acts of a handful of individuals and organizations, without rational grounding in general realities in the foundation field.<sup>1</sup>

The fabled Ford Foundation grants to the former staffers of Senator Robert Kennedy, D-N.Y., commonly bulk large in these views. McGeorge Bundy, then president of Ford, is a principal villain. A recent biography, reciting a series of grants made under his direction and noting his testimony in the 1969 foundation hearings, concludes that “Congress . . . proceeded to punish Bundy — perhaps as much for his unapologetic demeanor as for his political activities — by enacting legislation that forced all foundations to pay 4 percent tax [and limited foundations in a variety of other respects].”<sup>2</sup> A recent letter to me from the editor of a prominent periodical on philanthropy expresses profound doubt “that there were widespread, genuine abuses which justified the assaults of TRA '69.”

Significant aspects of the 1969 legislation did appear abruptly, without foreshadowing, in the House Ways and Means proceedings of that year. In the main, however, the 1969 legislation was not a congressional bolt from the blue. The concerns of Congress at which the law struck had roots reaching back for more than two decades, and its core restrictions on the personal use and financial practices of foundations had solid policy justification. An understanding of

<sup>1</sup>Except as otherwise noted, I use the terms “private foundation” and “foundation” interchangeably throughout this paper. I use “charity” and its derivatives to include all organizations listed in section 501(c)(3) of the 1986 Internal Revenue Code except organizations “testing for public safety” (which have never been entitled to receive deductible charitable contributions).

<sup>2</sup>Kai Bird, *The Color of Truth*, 377-388, at 388 (1998) (a biography of both McGeorge Bundy and his brother, William).



this history is essential to sound evaluation of what Congress did in 1969.<sup>3</sup>

## II. The 1950 Legislation — and Rumblings

In his January 1950 tax message to Congress, after recommendations that produced the first unrelated business in-

<sup>3</sup>The most comprehensive description of the published sources on this subject is Congressional Research Service, *Development of the Law and Continuing Legal Issues in the Tax Treatment of Private Foundations*, Prepared for the Subcommittee on Oversight of the House Ways and Means Committee, 98th Cong., 1st Sess. (WMCP 98-9 1983). Also useful are Staff of the Joint Committee on Taxation, *Description of Income Tax Provisions Relating to Private Foundations*, Prepared for Hearings Scheduled Before the Subcommittee on Oversight of the Committee on Ways and Means on June 27, 28, and 30, 1983 (JCS-31-38 1983) (“Joint Committee Description”) and Williams & Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations* (1975), reprinted in IV Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs: *Taxes* 2099 (1977).

come tax, President Truman referred separately to use of “the exemption accorded charitable trust funds . . . as a cloak for speculative business ventures” and consequent misuse of “funds intended for charitable purposes. . . .”<sup>4</sup> Treasury Secretary Snyder explained the Administration’s concerns to the Ways and Means Committee more fully:

Another . . . abuse of tax exemption involves the establishment of so-called charitable foundations or trusts which serve as a cloak for controlling businesses. The present law permits the transfer of business investments to tax-exempt trusts and foundations for these purposes without payment of estate or gift taxes. The income subsequently received from the business is exempt from income tax.

The abuse to which this type of device lends itself is the retention and reinvestment of a major share of the trust income in a manner which will benefit the grantor.

One method to eliminate this abuse would be to require that such trusts or foundations pay out substantially all net income within a specified period after the close of every taxable year. A further requirement should be a prohibition against dealings between the trust and its creator or businesses under his control and against the use of the trust for the personal advantage of the grantor.<sup>5</sup>

After extended hearings and a careful study of the subject,<sup>6</sup> in June of 1950 the Ways and Means Committee proposed legislation that would, generally, have (1) precluded foundations from entering into financial transactions with their contributors, officers, directors, trustees, and certain related parties, (2) taxed investment income not currently distributed for charitable purposes, and (3) denied charitable deductions for contributions of family controlled businesses to family foundations. The Committee explained its actions as follows:

Your committee’s study of the operations of exempt charitable, etc., trusts and other organizations has revealed a number of cases where it appears that donors of trusts and foundations either have derived, or at least have had the opportunity to derive, substantial benefits from their dealings with trusts or foundations.<sup>7</sup>

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<sup>4</sup>Message from President Truman, January 23, 1950, reprinted in 55 *United States Revenue Acts, 1909-1950* 2, 4 (B. Reams, Jr., ed. 1979) (Reams). The reference to these problems in the January 1950 presidential message indicates that the underlying Treasury investigation of them must have been completed by 1949 and suggests that the problems themselves among “so-called charitable foundations or trusts” had become sufficiently widespread and serious to warrant a Treasury legislative recommendation for some period before that.

<sup>5</sup>Revenue Revisions of 1950: Hearings on H.R. 8920 Before the House Committee on Ways and Means, February 3, 1950, 81st Cong., 2d Sess. 19 (1950) (Statement by Hon. John W. Snyder, Secretary of the Treasury), *id.* at 19.

<sup>6</sup>Joint Committee Description at 20; Staff of Senate Comm. on Finance, 89th Cong., 1st Sess., Treasury Department on Private Foundations (Comm. Print 1965), February 2, 1965 at 1.

<sup>7</sup>H.R. Rep. No. 2319, 81st Cong., 2d Sess. 42 (1950), 1950-2 Cum. Bull. 412.

The tax-exemption privileges with respect to investment income should be restricted to that portion of the income which [foundations] demonstrate that they are using to fulfill their charitable, etc., purposes by actual distribution to charity as the income is received by them.<sup>8</sup>

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Frequently families owning or controlling large businesses set up private trusts or foundations to keep control of the business in the family after death. . . . To prevent the avoidance of income, estate, and gift tax liability in such cases, your committee’s bill provides that no charitable deduction be allowed to a contributor for income, estate, and gift tax purposes if [the contributor and related parties control the trust or foundation to which the contribution is made and also control the business corporation whose stock is contributed]. . . . Your committee believes that denial of deductions in such cases is simply a recognition of the fact that where such control exists no completed gift for which a deduction should be granted has been made.<sup>9</sup>

The House approved the Ways and Means Committee proposals and sent the legislation to the Senate. Secretary Snyder’s statement to the Finance Committee summarized the reasons for the House action (and the Administration concerns):

The House bill also contains provisions for preventing private exploitation of charitable trusts and foundations for tax avoidance purposes. The institutions affected are privately controlled and do not obtain financial support from the general public. Some of them were established with a view to securing unintended tax benefits for the founders and members of their families by enabling them to retain control over business activities. The provisions of the bill can be expected to reduce the use of nominally charitable and educational organizations for the purpose of bestowing tax exemption on private interests.<sup>10</sup>

The Finance Committee, however, converted the House self-dealing prohibitions to requirements that financial transactions between foundations and insiders comport with arm’s-length standards, and it deleted the two other House provisions in favor of an information disclosure requirement. The Conference Committee adopted the Senate positions on self-dealing and contributions of business interests, but denied exemptions where accumulations of income were (1) unreasonable in amount or duration, (2) used to a substantial degree for other than exempt purposes,

<sup>8</sup>*Id.* at 411.

<sup>9</sup>*Id.* at 413-414.

<sup>10</sup>Revenue Revisions of 1950: Hearings on H.R. 8920 Before the Senate Committee on Finance, July 5, 1950, 81st Cong., 2d Sess. 6 (1950) (Statement by Hon. John W. Snyder, Secretary of the Treasury) as reprinted in 57 *United States Revenue Acts, 1909-1950* 7 (B. Reams, Jr., ed. 1979).

or (3) invested in such a manner as to jeopardize the carrying out of exempt functions.<sup>11</sup>

While the 1950 legislation left the term “foundation” undefined, its approach was essentially the same as that of the 1969 definition of “private foundation:” it applied its new restrictions to all charities included in the general charitable exemption section, but then proceeded to except what have come to be known as “public charities,” in categories largely the same as those enumerated in 1969.<sup>12</sup> The grounds specified for differentiating private foundations from other types of charities were that churches, schools, publicly supported organizations, and the other excepted charities “are in general what might be called ‘public’ organizations and because of this characteristic are not believed likely to become involved in” abuses of the sort which the new rules addressed.<sup>13</sup> With those phrases, Congress first sounded a theme that has governed the development of the law in this field from that day to this.

### III. From 1950 to 1964

Despite the much more rigorous positions taken by the Ways and Means Committee and approved by the House, the restrictions on private foundations that emerged from the 1950 legislative process were, then, quite modest. They did little to stem rapid growth in the number of foundations<sup>14</sup> and the increasing tide of attention in the business and tax press to the usefulness of the private foundation for tax avoidance and personal benefit. An article in *Business Week* is illustrative (and the italics are those of the original):

*Have you ever thought about setting up a “family foundation”?*

<sup>11</sup>PL. 814, 81st Cong., 2d Sess., section 331, adding sections 3813 and 3814 to the Internal Revenue Code of 1939.

<sup>12</sup>Internal Revenue Code of 1939, section 3813(a); Internal Revenue Code of 1954, section 509(a). The principal substantive differences between the 1950 and 1969 provisions are in the broader 1969 exception for organizations supporting other public charities (and certain other kinds of exempt organizations), specified in section 509(a)(3), and the elaborate section 509(a)(2) provision for publicly supported charities receiving related business income.

Congress first separated the rough equivalent of today’s public charities from other tax-exempt organizations in 1943 when, in expressing its concern about the growing acquisition and operation of unrelated businesses by exempt organizations but noting a lack of data necessary to deal with the problem, it first required annual information returns from most exempt organizations. H.R. Rep. No. 871, 78th Cong., 1st Sess. 24 (1943) and S. Rep. No. 627, 78th Cong., 1st Sess. 21 (1943), both reprinted in 110 Reams; Revenue Act of 1943, Pub. L. 235, section 117, adding section 45(f) to the 1939 Internal Revenue Code. The Committee Reports offer no explanation for the exception of public charities from the general reporting requirement, and when Congress dealt with the substantive problem — by the 1950 unrelated business income tax — in the charitable field it applied the same remedy to private foundations and public charities alike, excepting only churches (and conventions or associations of churches). Revenue Act of 1950, Pub. L. 814, 81st Cong., 2d Sess., section 301, adding sections 421-423 to the 1939 Code.

<sup>13</sup>Joint Committee Description at 20, quoting from S. Rep. No. 2375, 81st Cong., 2d Sess. 38 (1950).

<sup>14</sup>A 1954 *New York Times* article on foundations noted that the “enormous growth of foundations. . . is still on the increase.” Eagan, *New York Times*, March 1, 1954.

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However, before you get serious, there are two prime questions: First, are there certain philanthropies (religious, educational, medical, etc.) that you’d willingly devote considerable time and money to in later years? And second, *do you have a sizable family business that you want to pass control of to your heirs, despite crippling Federal estate taxes?* If your answers are “yes,” then a private foundation could be a way to give your “estate plan” an entirely new outlook.

*What is a foundation? It’s a nonprofit organization with its own capital fund, that uses its resources solely for public welfare. It can be a state-chartered corporation, or a trust, or an unincorporated association. If properly set up (with special Treasury-approved tax status) it pays no Federal taxes at all; yet it can be kept entirely under the control of its founder and his family.*

*The real motive* behind most private foundations is keeping control of wealth (even while the wealth itself is given away).

Take the typical case: Say the bulk of your property is in a family business. When you die, if you have a high-bracket estate, the estate tax could cause a forced sale of part or even all of the business — your children might lose control of the company, as well as have to sell their shares at a poor price.

A foundation can prevent this. You set it up, dedicated to charity. *Year by year, you make gifts of company stock to it, until the value of your remaining holdings is down to the point where eventual estate taxes could be paid without undue strain, or until the foundation’s holdings constitute firm control of the company.* You maintain control of the foundation while you live; you direct its charitable activities — and so, indirectly, you control the shares in your company that have been donated. When you die, control of the foundation passes from you to your family or other persons you trust and thus they, in turn, keep reins on the business.<sup>15</sup>

With advice like this inundating both the well-to-do and their tax advisors during much of the 1950s and 1960s, the private foundation enjoyed a rapidly accelerating wave of popularity. When I entered law practice in 1958, the private foundation had become the subject of broad discussion — and general recommendation — in the literature directed to tax lawyers and estate planners. Planners were counseled to bear the foundation firmly in mind particularly wherever a client had a substantial interest in a business.<sup>16</sup> The key virtue of the foundation, according to this advice, lay in the access it afforded to generous income and estate tax deductions

<sup>15</sup>*Business Week*, May 7, 1960, at 153.

<sup>16</sup>*E.g.*, J.K. Lasser *Tax Reports*, August 15, 1954 (“[T]he owner of a business may create a foundation so as to cut his estate tax and leave his family in control of the business after death. . . .”); Weithorn and Noall, *Dealings Between Donor and Foundations*, 6th Biennial New York University Conference on Charitable Foundations 129, esp. 154-155 (section on “Maintaining and/or Gaining Control of Businesses”) (1963).

accompanied by its broad flexibility to suit the personal needs of the donor. Charity was, of course, always mentioned, but so long as one took care to include a modest quantity of magic language insisted upon by the IRS in the foundation's organizational documents and exemption application, the message was clear that the highly imprecise legal requirements could readily be managed if and when they became practically relevant in the dim and indefinite future.

The conclusion of an extensive article on "Donor Foundation Dealings" typifies the view of the law common even to the most serious and balanced legal writing of the period:

[The] statutory standards are either very vague or . . . so specific as to be relatively useless. . . . Many of the difficulties in the charitable [i.e., in this context, foundation] area appear to derive from the willingness of the tax law to permit control by a donor or person under his influence. . . . [Absent] the enactment of more stringent legislation . . . preservation of the public interest will depend, in the last analysis, upon the dictates of conscience of philanthropists [i.e., donors].<sup>17</sup>

By 1961 the private foundation's popularity and the ever-widening publicity about its utility for personal, non-charitable purposes first drew the attention of Congressman Wright Patman, D-Texas. Patman issued the first two of his later-multiplying negative reports on foundations in 1962 and 1963.<sup>18</sup> He was, though, cordially detested in much of Congress, a feeling shared by key members of the tax-writing committees, and in their early stages his activities attracted little noticeable attention elsewhere in Congress.<sup>19</sup>

#### IV. The Revenue Act of 1964

A more reliable signal of events ahead came from the Ways and Means Committee in 1963. As it proceeded with the legislation that became the Revenue Act of 1964, the committee pointedly excluded private foundations from its general expansion of the class of organizations entitled to

receive charitable contributions deductible by individuals up to 30 percent of adjusted gross income.<sup>20</sup> The Committee Report explanation of the action is brief and confined to a single, limited concern with foundations. Discussion in the Peterson Commission hearings in August 1969, however, indicated that the real basis for the committee's decision was a more generalized dissatisfaction with, and suspicion of foundations.<sup>21</sup>

In January, 1964, the Senate Finance Committee turned its attention to the 1964 Revenue Act. In the executive sessions of the Finance Committee, Treasury attempted to kindle interest in a measure originally proposed by President Kennedy in his 1963 tax message but not adopted by the Ways and Means Committee — repeal of the unlimited charitable contribution deduction. The examples Treasury used to illustrate the effect of the unlimited deduction included some situations in which the recipients of the contributions were private foundations. In the ensuing discussion, it quickly became apparent that the members of the Finance Committee were far more interested in private foundations than in the unlimited contribution deduction — or, it seemed at the time, any other part of the 1964 Act. Treasury was sent scurrying to gather additional information about foundations; the questioning of Treasury personnel by committee members showed keen interest in the subject; and Treasury faced the prospect of considerable delay of the committee's decisions on the major provisions of the 1964 Act.

To avert this sidetracking of the act, Treasury promised the Finance Committee to conduct a thorough study of private foundations and report its findings, conclusions, and recommendations to the committee by early 1965.<sup>22</sup> That promise given, the committee returned to its decisions on the 1964 Act, satisfying its worries about foundations, for the time being, by excluding private foundations from qualification to receive unlimited charitable deductions and correlative restriction of the act's liberalizations of the charitable deduction. The effect was to preserve and expand charitable contribution benefits for public charities, but to contract them or refuse their expansion for private foundations.

The Finance Committee made no secret of the grounds for its jaundiced view of private foundations:

Your committee believes that the special advantage of the unlimited charitable contribution deduction

<sup>17</sup>Young, *Donor Foundation Dealings*, 22d Annual New York University Institute on Federal Taxation 965 at 1006 (1964).

<sup>18</sup>"Tax-Exempt Foundations and Charitable Trusts: Their Impact on our Economy," Subcommittee No. 1, Select Committee on Small Business of the House of Representatives, December 31, 1962 and October 16, 1963.

<sup>19</sup>When we at Treasury prepared an early draft of the Treasury Report on Private Foundations, naively including fulsome credit to Patman for his work on foundations, Dr. Laurence Woodworth, then Chief of Staff of the Joint Committee on Internal Revenue Taxation, sternly advised us to keep any reference to Patman to an absolute minimum. As a staff member of the Joint Committee for well over 30 years, Woodworth was steeped in private opinion within Congress, and he was particularly sensitive to the views of the members of the tax-writing committees, for whom he worked directly. He told us of the attitude toward Patman described in the text and noted that linking the Treasury recommendations to him would poison their chances of passage. On that advice, we limited the basic reference to the Patman work to a single footnote, printed in barely legible type. The effusive reception subsequently accorded Patman when he appeared in the 1969 Ways and Means Committee hearings owed simply to the tradition of congressional courtesy (and says much of its general candor).

<sup>20</sup>H.R. Rep. No. 749, 88th Cong., 1st Sess. 53 (1963), 1964-1, Pt. 2 Cum. Bull. 177.

<sup>21</sup>Commission on Private Foundations and Public Philanthropy, chaired by Peter G. Peterson (1969). Thomas Curtis, who had been a Republican member of the Ways and Means Committee in 1963, and Stanley Surrey, who had been the Treasury Assistant Secretary for Tax Policy then, both of whom were present at the Peterson Commission hearing in which this point was discussed — and who over many years had agreed on little else — concurred entirely in the Ways and Means Committee judgment described in the text. (While the report of the commission was subsequently published, I have not been able to find a public record of its hearings, and I have relied on my notes for the information reported here.)

<sup>22</sup>Treasury later extended the same promise to the Ways and Means Committee.

should not be made available in the case of these private foundations because frequently contributions to foundations do not find their way into operating philanthropic endeavors for extended periods of time. In the meanwhile, the funds are invested and the advantages arising from control of these investments are likely to inure to the principal contributors to the foundations. Thus, your committee concluded that if the 20- or 30-percent limitations with respect to charitable giving are to be removed for those desiring to make large contributions there should be no question that the bulk of the funds involved, within a reasonable period of time, are devoted to charitable and philanthropic purposes.<sup>23</sup>

The Conference Committee extended qualification to receive unlimited charitable contributions to operating and pass-through foundations. As a condition of that qualification, however, it fastened tight rules against most types of self-dealing — reminiscent of the Ways and Means Committee prohibitions in 1950 and foreshadowing the section 4941 restrictions in 1969 — on both of those classes of private foundations.<sup>24</sup>

## V. The 1965 Treasury Report

In the spring of 1964 Treasury began work on its promised report on private foundations.<sup>25</sup> To provide the data necessary for its analysis, it assembled information from a variety of sources. It conducted a special survey of a statistically selected stratified sample of about 1,300 foundations, including all foundations with assets of \$10 million or more. It consulted with the IRS and the Justice Department to determine their experience in the administration of the tax laws then govern-

ing foundations. Douglas Dillon, Treasury Secretary at the time, had been much involved in the foundation community while he was an investment banker in New York, and he appointed an “Informal Advisory Committee on Foundations,” composed of foundation people whom he trusted to give candid insight into the field. The committee met repeatedly with Treasury and provided a good deal of useful information.<sup>26</sup>

Treasury also drew together an informal group of lawyers having special experience and expertise with foundations, and that group was a continuing source of helpful advice.<sup>27</sup> Treasury reviewed the Patman materials then available,<sup>28</sup> found much of the data unreliable, some of it highly so, but made use of whatever solid information its Office of Tax Analysis could cull from the assemblage. From these and other sources, it compiled and tabulated a variety of classes of relevant data.

Treasury submitted its Report on Private Foundations to Congress early in 1965, and shortly thereafter the Senate Finance Committee published the report for informational purposes.<sup>29</sup> The report had high praise for the capacities of private foundations:

Private philanthropic organizations can possess important characteristics which modern government necessarily lacks. They may be many-centered, free of administrative superstructure, subject to the readily exercised control of individuals with widely diversified views and interests. Such characteristics give these organizations great opportunity to initiate thought and action, to experiment with new and untried ventures, to dissent from prevailing attitudes, and to act quickly and flexibly. Precisely because they can be initiated and controlled by a single person or a small group, they may evoke great intensity of interest and dedication of energy.

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<sup>23</sup>S. Rep. No. 830, 88th Cong., 2d Sess. 60 (1964), 1964-1 Cum. Bull. 564.

<sup>24</sup>Revenue Act of 1964, Pub. L. 88-272, section 209, adding section 170(g) to the 1954 Internal Revenue Code.

Technical aspects aside, an “operating foundation” is, generally, a foundation that conducts charitable activities itself, rather than making grants to support the charitable activities of others. Examples are museums, historical sites, and parks supported largely or entirely by their own endowments or by contributions from a single donor or family — operating entities, that is to say, without sufficiently broad public support to qualify as public charities. A pass-through foundation is, generally, a foundation that distributes much or all of the contributions to it, soon after receiving them, for charitable use other than by a non-operating private foundation or (after 1969) an organization controlled by the pass-through foundation or its insiders. Operating foundations comprise a small part of the total foundation universe, which is generally made up of endowed grant-making foundations supporting the charitable work of others with income produced by their endowments or portions of the endowments themselves. The definitions of “operating foundation” and the descriptions of “pass-through foundation” (not a legally defined term) differed in significant particulars in the 1964 and 1969 Acts. Their current formulations are in sections 4942(j)(3) (operating foundation) and 170(b)(1)(E)(ii) (pass-through foundation) of the 1986 Internal Revenue Code.

<sup>25</sup>As an attorney in Treasury’s Office of Tax Policy, I participated extensively in drafting the Treasury Report (although I had little to do with its fundamental policy decisions). Readers must make their own judgments of the success of my effort to keep my comments here free from consequent bias.

<sup>26</sup>The Informal Advisory Committee on Foundations had completed its meetings by the time I joined Treasury at the beginning of August, 1964, and although I had full access to the detailed minutes of its discussions, I do not now have a list of its members (at the time, a tightly guarded secret). My only relevant memory is of being told several times that F. Emerson Andrews, then Director of The Foundation Library Center (later redesignated “The Foundation Center”) and generally regarded as an *éminence grise* in the foundation field, had been a particularly active and valuable participant.

<sup>27</sup>Among the most conscientious and consistently insightful members of the lawyers group were Harry Mansfield, of Ropes & Gray, David Watts, of Dewey, Ballantine, et al., Adrian W. DeWind, of Paul Weiss, et al., Bernard Wolfman, then a professor at the University of Pennsylvania Law School, recently having left practice at the Philadelphia firm of Wolf, Block, and Schorr, and Albert M. Sacks, then a professor at, and later dean of the Harvard Law School, who had written extensively on foundations.

<sup>28</sup>Patman held a hearing on foundations in the summer of 1964, and the transcript of the hearing was published as the Treasury work proceeded.

<sup>29</sup>Staff of Senate Comm. on Finance, 89th Cong., 1st Sess., Treasury Department on Private Foundations (Comm. Print 1965), February 2, 1965 (“Treasury Report” or “Report”).

Private foundations have also preserved fluidity and provided impetus for change within the structure of American philanthropy. Operating charitable organizations tend to establish and work within defined patterns. The areas of their concern become fixed, their goals set, their major efforts directed to the improvement of efficiency and effectiveness within an accepted framework. Their funds are typically consigned to definite — and growing — budgets. The assets of private foundations, on the other hand, are frequently free of commitment to specific operating programs or projects; and that freedom permits foundations relative ease in the shift of their focus of interest and their financial support from one charitable area to another. New ventures can be assisted, new areas explored, new concepts developed, new causes advanced. Because of its unique flexibility, then, the private foundation can constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity.<sup>30</sup>

The report rejected the contentions, originating with Patman but by then having spread to some others, that foundations had become a disproportionately large share of our national economy and that they represented dangerous concentrations of uncontrolled economic and social power. It consequently rejected calls for the imposition of a time limit on the lives of all private foundations.<sup>31</sup>

Nonetheless, Treasury found serious abuses among a minority of foundations, and it recommended legislation to deal with them. The core proposals were a general interdiction of self-dealing transactions, a requirement for annual foundation payouts for charitable purposes, and restrictions on business holdings.

The recommendation on self-dealing reviewed experience with the 1950 Act's arm's-length standards, dependent as they were on such inherently ambiguous terms as "substantial," "adequate," and "reasonable," and concluded that experience had demonstrated them to be difficult and expensive to administer without producing correlative advantage for charity. The report offered 12 (by no means exhaustive) examples of the sorts of problems which concerned Treasury. The substance of its legislative recommendation was incorporated in section 4941 in 1969.<sup>32</sup>

The case for the report's proposal of required annual payouts noted that the assumption underlying the charitable deduction — that loss of tax revenues will be offset by use of the contributed funds advance the public welfare — loses force when private foundations which do not conduct active

charitable programs are permitted to retain both the contribution and the income produced by it for indefinitely long periods. Pointing out that deficiencies in the 1950 restrictions on income accumulations had made the law difficult and costly to administer — and that, in any case, the law did not apply to foundation assets other than realized income — the report recommended a rule for nonoperating foundations compelling, generally, payout of the greater of the foundation's realized income or a percentage of its net investment asset value.<sup>33</sup> Treasury suggested that, at the time of the report, an appropriate payout percentage would be in the range of 3 to 3-1/2 percent. The substance of the proposal was incorporated in section 4942 in 1969, though with the payout percentage set at 6 percent. Subsequent amendments have eliminated the income payout aspect of the rule and stabilized the percentage payout at 5 percent.

The report's third and fourth recommendations dealt with "unrelated" businesses.<sup>34</sup> For foundation ownership of substantial interests in such businesses, Treasury proposed a 20 percent limit on holdings in any one business enterprise, with transition periods for foundations to dispose of holdings exceeding the limit. For situations in which donors retained both control over business interests contributed to foundations and ownership interests in the businesses themselves, it proposed deferral of the charitable deduction until, generally, donor control over the contributed interest ceased or the foundation disposed of it.<sup>35</sup>

Treasury elaborated several concerns with these situations, including particularly aggravated self-dealing and deferral of charitable benefit problems in such contexts and competitive advantage for foundation-owned businesses. At the heart of Treasury's case, though, was its finding, on examination of the substantial business interests of the foundations covered in its special survey, that those interests were extraordinarily unproductive for charity.

Of the 213 business holdings of 20 percent or larger size, almost precisely half had no current yield whatever in the

<sup>30</sup>Treasury Report at 12-13.

<sup>31</sup>*Id.* at 13.

<sup>32</sup>Because the 1969 Act included its rules in the Internal Revenue Code of 1954, statutory references from this point forward are, except as otherwise noted, to that Code. The section numbering has, though, generally been carried without change into the Internal Revenue Code of 1986, and remains accurate today. The special provisions of sections 4941(d)(1)(F) and (d)(2)(G) for government officials have a narrow and altogether different history, beyond the scope of this paper.

<sup>33</sup>The limitation of the payout requirement to nonoperating (that is to say, grant-making) foundations follows from the objective of the requirement to compel current charitable use of at least a specified minimum quantum of foundation assets. By their nature, operating foundations put to present charitable use whatever amounts are necessary to meet the definitional specifications for "operating" status. Hence, if the definition is sound (and the present definition has been somewhat expanded beyond that contemplated by Treasury), there is no need to apply the payout rule to them, and, in addition, they are entitled to receive "qualifying distributions" — distributions counting toward the payout requirement — from nonoperating foundations so long as they are not controlled by the distributing foundation or its insiders.

<sup>34</sup>That is, businesses "not substantially related" to the foundations' charitable purposes within the meaning of section 513(a).

<sup>35</sup>The latter recommendation also addressed maintenance of donor control over non-business property given to foundations, such as fractional interests in works of art or vacant land. Amendments of the charitable deduction rules in 1969 largely dealt with this problem. Sections 170(e)(1)(B)(i) and (f)(3)(A).

surveyed year.<sup>36</sup> Overall the average yields were far less than the average yield of the Dow Jones stocks for the same year — by one computation exactly half of the Dow figure. Among the 50 percent or larger interests, where the foundations were ordinarily in clear command of the businesses, more than 70 percent produced no current yield for charity at all. Nor did the Treasury data show that, in general, the unfavorable current performance was balanced by unusual appreciation of the foundation interests.<sup>37</sup> Indeed, the data tended to show the contrary. Although the Treasury data were hardly definitive, they were derived directly from foundations' own responses to the question on this point in the Treasury survey and, hence, presumably were generally fair to foundations.

Reviewing this scene, Treasury found it difficult to escape the conclusion that, in the main, the foundation (or foundation/donor) business interests were held for reasons other than their advantage to foundations' charitable beneficiaries. Where the businesses were successful, they carried prestige and power for their executives (often also the foundation executives); the foundations often afforded convenient parking places for stock which families wanted to protect from takeovers; and the businesses had competitive advantage over those whose private shareholders were less tolerant of absent or long-deferred yields. Where the businesses were unsuccessful — the more usual case — that fact would commonly become apparent only long after the donors had been accorded substantial tax deductions for their contributions; charitable benefits would at best be considerably delayed; and, more often, charitable assets would be altogether lost. Hence, judging the self-dealing and payout recommendations by themselves insufficient to cope with these problems,<sup>38</sup> Treasury found pronounced advantage in moving foundation funds, over time, away from a class of holdings which had proved to be productive of a variety of abuses and, on the whole, strikingly unproductive of benefit to charity. The 1969 Act melded Treasury's two recommendations on this point into the single set of interlocking rules of section 4943.

The Treasury Report made several other recommendations, but none of the importance which it attached to those aimed at self-dealing, payout failure, and business holdings. A minor proposal to control trading and speculation, which Treasury found only among a small group of foundations, became the basis in 1969 for the "jeopardy investment" provision of section 4944. A proposal on foundation borrowing to acquire investment assets assumed broad importance for public charities and other classes of exempt organizations when the Supreme Court approved capital gains treatment for sellers of businesses to exempt organizations in "bootstrap" transactions.<sup>39</sup> The result became the 1969 tax on

"unrelated debt-financed income," set out in section 514 and applicable to exempt organizations generally, though of only limited significance for private foundations themselves because of the section 4943 stricture against their purchase of unrelated businesses.<sup>40</sup> Other of the report's proposals triggered other 1969 legislation, also of limited import for foundations generally.<sup>41</sup>

The report did not recommend sanctions to enforce its substantive proposals, noting only that the sanctions of existing law — denial of exemption and qualification to receive deductible contributions — would have to be reexamined and that the objective of the compliance mechanism should be "to make certain that funds committed to charity . . . will in fact be devoted to charitable ends."<sup>42</sup> Treasury worked extensively with the Joint Committee staff between 1965 and 1969 to devise appropriate sanctions, and by the Spring of 1969 the present enforcement regime for the Chapter 42 rules had been developed.

## VI. From 1965 to 1969

As soon as the Treasury Report was published, Congressman Patman denounced it vigorously as far too mild, as did Senator Albert Gore, D-Tenn.; (the father of Vice President Al Gore), who was a member of the Senate Finance Committee and already a strong opponent of foundations. The Ways and Means Committee requested written comments on the report and received them from more than 70 foundations, law and accounting firms, and individuals. Most of the adverse comments lacked substantial evidence, resulted from misunderstandings of the report, or dealt only with legalistic detail.<sup>43</sup> While both Treasury and Joint Committee staffs spent a good deal of time analyzing the comments, so far as I am aware they had little effect on the 1969 legislation.

Except for the acceleration of bootstrap sales of businesses to charities induced by the *Clay Brown* decision, the substance of the reality that Treasury had reviewed changed in no significant respect from 1965 to 1969; but the perception of

<sup>40</sup>A proposal for the broadening of foundation management beyond donors and related parties after 25 years of an organization's existence had not been a focus of attention during the main stage of development of the Treasury Report, was added late in the drafting process, and disappeared entirely in 1969. Treasury Report, 54-57.

<sup>41</sup>Including, for example, the proposals for the reduction of charitable deductions for the ordinary income contributed property would have produced if it had been sold (a problem which Treasury took care to point out was not confined to donors to private foundations) and for modest dollar penalties for failure to file information returns. *Id.* at 60-63, 64; sections 170(e)(1)(A), 6652(c)(1), and (2), respectively. As subsequent discussion in this paper indicates, though, the Treasury Report did not propose the 1969 restrictions on foundation programmatic activities (section 4945), the tax on foundation income, or the reduction of the charitable deduction for contributions of capital gain property.

<sup>42</sup>Treasury Report 3, footnote 9.

<sup>43</sup>A marked exception — indeed, standing far above the rest of such comments — was Professor John Simon's thoughtful paper. House Committee on Ways and Means, 89th Cong., 1st Sess., Written Statements by Interested Individuals and Organizations on Treasury Department Report on Private Foundations (1965), Vol. I beginning at 446.

<sup>36</sup>The data described here were produced by Treasury's Office of Tax Analysis and cited in an article I wrote before I left Treasury. See *The Treasury Department Report on Private Foundations: A Response to Some Criticisms*, 13 UCLA Law Review 965, 983-985 (1966).

<sup>37</sup>Several cases of very marked appreciation were reported, but overall they appeared to be sharp deviations from the norm.

<sup>38</sup>Treasury Report, 23-24.

<sup>39</sup>*Commissioner v. Clay B. Brown*, 380 U.S. 563 (1965).

it, in Congress and in the broader public, surely did. Patman's prior fire on foundations became a fusillade. Probably caused in part by the Treasury Report, articles multiplied in the business and tax press portraying foundations as attractive devices for wealthy individuals to avoid tax. Discussions of tax loopholes in the popular press intensified, and it was a rare article indeed that did not list foundations among the "loopholes."

## VII. The 1969 Act

A wave of national support for tax reform followed Treasury Secretary Joseph Barr's January 1969 congressional testimony about strikingly successful tax avoidance by high income individuals. The Ways and Means Committee promptly scheduled hearings — and placed foundations at the top of the list of subjects to be considered.

### 1. The Ways and Means Committee — Framework of the 1969 Law

The fundamental framework of the 1969 foundation legislation appeared early in the Ways and Means Committee proceedings. The Treasury Report had been published slightly more than four years before, and its major features had been widely reported and discussed. Larry Woodworth, still Chief of Staff of the Joint Committee on Internal Revenue Taxation<sup>44</sup> and in unquestioned control of all tax staff work for both Houses of Congress, was thoroughly familiar with the Treasury Report, and it would have been customary for him to brief Chairman Mills and the Committee's senior Republican, John Byrnes of Wisconsin, on it before the hearings began. Indicating early interest in the report, the committee invited Larry Stone, who had been Treasury's Tax Legislative Counsel when the report was prepared, to explain the Treasury recommendations to the committee members close to the beginning of the hearings.

Larry's testimony was received with unusual warmth. As the week proceeded, questioning of other witnesses suggested broad sympathy with the principal Treasury positions. When I appeared at the conclusion of the foundation portion of the hearings, the response was again cordial and warm, and Chairman Wilbur D. Mills, D-Ark. — by far the best indicator of the predominant committee views — strongly suggested agreement with the core Treasury proposals. Even then, it seemed clear that there would be foundation legislation in 1969 and that the Treasury Report would establish its fundamental framework.

### 2. Congressional Rationale for Actions on Self-Dealing, Payout, and Business

As the opening of the legislative process in the Ways and Means Committee foreshadowed, the conclusion of the process in Conference followed the substance of the central Treasury proposals closely. The Joint Committee's explanation of the grounds for the Congressional actions followed Treasury's analysis also, adding in only the theme provided by the

1965-1969 work to improve sanctions over prior law's denial of exemption.

For example, the Joint Committee stated the basis for the general proscription of self-dealing as follows:

To minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private foundations for noncharitable purposes, to provide a more rational relationship between sanctions and improper acts, and to make it more practical to properly enforce the law, the Act generally prohibits self-dealing transactions and provides a variety and graduation of sanctions. . . . This is based on the belief by the Congress that the highest fiduciary standards require complete elimination of all self-dealing rather than arm's-length standards.<sup>45</sup>

Again, the reasons for the payout rules:

Under prior law, if a private foundation invested in assets that produced no current income, then it needed to make no distributions for charitable purposes. As a result, while the donor may have received substantial tax benefits from his contribution currently, charity may have received absolutely no current benefit. In other cases, even though income was produced by the assets contributed to charitable organizations, no current distribution was required until the accumulations became 'unreasonable'. . . . Moreover, as was the case with self-dealing, it frequently happened that the only available sanction (loss of exempt status) either was largely ineffective or else was unduly harsh.

. . . [Consequently, t]he act . . . provides that private foundations must distribute all income currently (but not less than 6 percent of investment assets), and imposes graduated sanctions in the event of failure to distribute.<sup>46</sup>

The explanation of the limits on excess business holdings lifted the first three examples directly from the relevant section of the report:

The Treasury Department in its 1965 study of private foundations included the following examples of where business, and not charitable, purposes appeared to predominate in foundation activities:

**Example 1.** — The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately \$10,500,000 at the end of 1962 and with gross receipts

<sup>45</sup>General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970 (Joint Committee Explanation), 30-31.

<sup>46</sup>*Id.* at 36-37.

<sup>44</sup>A title later abbreviated to the *Joint Committee on Taxation*.

of more than \$17 million for that year. Another of the corporations operates the largest radio broadcasting station in the state. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than \$20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in one city, these properties present an economic empire of substantial power and influence.

**Example 2.** — The *B* foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

**Example 3.** — The *C* foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.<sup>47</sup>

The Joint Committee then proceeded to elaborate the rationale underlying the excess business holdings limits:

Those who wished to use a foundation's stock holdings to acquire or retain business control in some cases were relatively unconcerned about producing income to be used by the foundation for charitable purposes. In fact, they might have become so interested in making a success of the business, or in meeting competition, that most of their attention and interest was devoted to this with the result that what was supposed to be their function, that of carrying on charitable, educational, etc., activities was neglected. Even when such a foundation attains a degree of independence from its major donor, there is a temptation for its managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable ownership predominates, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses. To deal with these problems, Congress concluded it is desirable to limit the extent to which a business may be controlled by a private foundation.<sup>48</sup>

<sup>47</sup>*Id.* at 40-41.

<sup>48</sup>*Id.* at 41.

### 3. The Program Restrictions

While the Treasury Report set the framework for the 1969 foundation legislation, it did not limit the content of the legislation. Developments in the course of the Ways and Means Committee hearings, unforeseen by most of us, led to restrictions on foundations' programmatic activities.<sup>49</sup>

Disquiet about foundations — already present in the Ways and Means Committee at least as early as 1963 and manifested much more sharply by the Finance Committee in January 1964 — grew gradually to a deepening sense of distrust among the Ways and Means members as the week of hearings proceeded. Genuine anger occasionally flashed from appearances like that of Congressman John Rooney, D-N.Y., who recounted his opponent's use of a foundation he controlled in his campaign to oust Rooney. Rooney alleged, for example, that the opponent would make a political speech at a church gathering and then present a check to the minister, representing a grant from his foundation to the church. Little could carry fear more directly to the heart of an incumbent member of Congress; and the rule against any foundation expenditure "to influence the outcome of any specific political campaign" doubtless received powerful thrust then and there.<sup>50</sup>

Other program restrictions stemmed, primarily at least, from Committee questioning of Mac Bundy about Ford Foundation grants.<sup>51</sup> The fabled Kennedy staff grants produced the limitation on grants to individuals "for travel, study, or similar purposes."<sup>52</sup> A Ford grant to the Congress on Racial Equality for voter registration, used by CORE for registration in heavily African-American areas of Cleveland during Carl Stokes' closely contested campaign for Mayor, led to the special restrictions on foundation voter registration activities.<sup>53</sup> Some sloppiness in the management of funds by Ford grantees in the Oceanhill-Brownsville school decentralization controversy in New York City had much to do with the expenditure responsibility rules.<sup>54</sup> The Oceanhill-Brownsville grants and perhaps other Ford grants appear also to have lent impetus to the limitation on foundation influencing of legislation.<sup>55</sup>

The final provision of the program restriction section of the law addressed no specific foundation program activity.

<sup>49</sup>Section 4945.

<sup>50</sup>Section 4945(d)(2).

<sup>51</sup>And from those seeds of reality largely sprouted the myth of Bundy's responsibility for the entire law.

<sup>52</sup>Section 4945(d)(3) and (g). In keeping with general committee report practice, the official Joint Committee Explanation (p. 48) names no names. The statements in the text of this paragraph are based on 1969 discussions of the author and others close to the legislation with Joint Committee staff members and were general knowledge at the time.

<sup>53</sup>Sections 4945(d)(2) and (f); Joint Committee Explanation, 48.

<sup>54</sup>Section 4945(d)(4); Joint Committee Explanation, 48.

<sup>55</sup>Sections 4945(d)(1) and (e); Joint Committee Explanation, 48, 49. Committee members appear to have thought that the school decentralization issue, for one, was a question for ultimate resolution by New York municipal "legislation," and Ford grantees seem clearly to have attempted to influence the outcome of the controversy.

Grounded in dissatisfaction with the latitude afforded charities by existing law to conduct some quantum of noncharitable activity, it imposed penalty tax on any foundation expenditure for a noncharitable purpose. It thereby, for foundations, eliminated a latitude which other charities retained.<sup>56</sup>

#### 4. The Tax and Reduction of the Charitable Deduction

Bundy's appearance in the Ways and Means hearings doubtless had its part in stimulating committee member antagonism toward foundations. He was smarter and more articulate than most people — by a considerable distance — and if he made any effort to conceal his sense of those capacities in his testimony, its effect was limited. By the end of his day at the witness table some members of the committee made no secret of their displeasure with him.

It would be quite wrong, though, to attribute the committee's mounting distrust of, and hostility toward foundations to Bundy alone. The members knew that the Treasury Report detailed a considerable number of specific examples of foundation activities falling far short of prompt and single-minded devotion to charitable works, and they had been told that the Treasury survey had revealed more such examples. Moreover, whatever their personal feelings about Congressman Patman, by 1969 the massive publicity generated by his investigations and reports surely contributed to their strong sense that all was not well in the foundation field.

Nonetheless, witness after witness from that field refused to concede that there was anything seriously wrong among foundations — or, at most, anything that more rigorous IRS enforcement of existing law (and, perhaps, a dose of supervision by state attorneys general) could not cure. Committee members grew more and more frustrated with these responses as the hearings wore on, and as their frustration grew, so did their distrust and hostility.

The Ways and Means Committee Report, then, tells only part of the story of the basis for the tax on foundation investment income:

Your committee believes that since the benefits of government are available to all, the costs should be borne, at least to some extent, by all of those able to pay. Your committee believes that this is as true for private foundations as it is for taxpayers generally. Also, it is clear that vigorous and extensive administration is needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes. This tax, then, may be viewed as being in part a user fee.<sup>57</sup>

The committee (and other bodies acting at subsequent stages in the legislative process), after all, did not require all charities — or all exempt organizations — to bear part of the costs of government, though surely at least a great many were as "able to pay" as foundations were. Nor did Congress apply the funds produced by the tax to intensified IRS monitoring

of foundations. The revenue from the tax flowed then, as it does to this day, into general federal revenues, adding its minuscule support to the building of B-2 bombers, the subsidies for private logging and cattle and sheep grazing on federal land, and the multitude of other federal expenditures whose bearing on the enforcement of private foundation laws is less than self-evident. A realistic account of the basis for the foundation tax can hardly ignore a deep-seated congressional distrust of, and displeasure with private foundations — which in 1969 surely burned most brightly in the Ways and Means Committee.<sup>58</sup>

Similarly, the reduction of the charitable deduction for contributions of capital gain property to most private foundations had not been proposed in the Treasury Report and first appeared in the 1969 Ways and Means Committee action on the foundation legislation.<sup>59</sup> The Joint Committee Explanation states no reason for the special adverse treatment of capital gains contributions to foundations.<sup>60</sup> Moreover, the contribution reduction took place in the setting of legislation designed to cut away every foundation abuse drawn to the attention of Congress and to fix foundation payout requirements deemed fully satisfactory. Here again, it seems difficult to escape the conclusion that the action sprang from a penumbra of congressional mistrust of foundations, exacerbated by the Ways and Means Committee proceedings.

#### 5. The Senate

The pattern of the 1969 legislation was established in the Ways and Means Committee, and the law remained unaltered

<sup>58</sup>The Senate reduced the tax dramatically, but the result in Conference swung well back toward the House position.

Both tax-writing committees were seriously and sincerely dissatisfied with IRS enforcement of the law governing foundations before 1969. Their expressions to that effect in the 1969 hearings — and the continuing attention to foundations by both committees and their subcommittees from then through 1984 — produced massively intensified auditing of foundations throughout the 1970s and impressive, though somewhat diminished, auditing through the 1980s (consistently showing high levels of foundation compliance with the 1969 rules). But the foundation tax never funded these or other IRS exempt organizations functions. Even when Congress earmarked the tax for those functions (and Employee Plans operations) in the 1974 ERISA legislation (adding section 7802(b)), the action lacked practical effect because it failed to commit the appropriations process. The Council on Foundations, Independent Sector, the Exempt Organizations Committee of the ABA Tax Section, and others repeatedly urged application of the foundation tax to its stated purpose, but Congress never responded; and it ultimately repealed the earmarking provision. Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, section 1101(a); H.R. Rep. No. 105-599, 105th Cong., 2d Sess. 211 (1998) (Conference Report). The Committee Reports explaining the repeal summarize this history. H.R. Rep. No. 105-364, Pt. 1, 105th Cong., 1st Sess. 40-41 (1997); S. Rep. 105-174, 105th Cong., 2d Sess. 19-21 (1998). In any case, as the reports note, the tax was from the first ill-suited to its purpose because the funding source and the IRS needs specified for funding would fluctuate from year to year without correlation to each other. *Ibid.*

<sup>59</sup>Section 170(e)(1)(B)(ii). The reduction does not apply to contributions to operating or pass-through private foundations.

<sup>60</sup>Joint Committee Explanation, 77-78.

<sup>56</sup>Section 4945(d)(5); Joint Committee Explanation, 51, 52.

<sup>57</sup>H.R. Rep. No. 413, 91st Cong., 1st Sess. 19 (1969).

in fundamental structure as it finally emerged from the legislative process. It was, of course, revised in a number of particulars as it went along, the most important of which I have noted<sup>61</sup> and the rest of which are beyond the scope of this paper. It is, though, worth pausing over one aspect of the action of the Senate Finance Committee and the Senate.

In the Finance Committee Senator Gore pressed vigorously for a 25 year limit on the lives of foundations. As we have seen, this limit had been Congressman Patman's primary call for reform for a number of years, and Senator Gore had embraced it at least as early as 1965. Other foundation critics had rallied around it as well.

Against energetic opposition within the Finance Committee, Senator Gore succeeded in achieving a compromise on a 40 year limit on the tax-exemption and income, estate, and gift tax charitable deductions for foundations. On the Senate floor, however, after a broad and lively debate, led on the foundation side by then Senator Walter Mondale, D-Minn., the limit was decisively defeated.<sup>62</sup> Even at the high-water mark of Congressional displeasure with foundations, then, so long as specifically targeted anti-abuse measures were in place, Congress decided that private foundations should remain a functioning part of American society, without a federally mandated restriction on the duration of their lives or their fundamental tax benefits. No such a limit has ever since been the subject of serious congressional consideration.

## VIII. The Private Foundation/Public Charity Dichotomy

### 1. Precedent

Was Congress justified in singling out private foundations for special restrictions in 1969?<sup>63</sup> It surely broke no new ground in doing so. As we have seen, it took aim at foundation self-dealing and income accumulations in the Revenue Act of 1950, and the Ways and Means Committee and the House even attempted to open fire on family foundation business interests then. The Revenue Act of 1964 expanded the differentiation of private foundations from public charities.

<sup>61</sup>That is, the changes in the tax and payout rates.

<sup>62</sup>The vote was 69-15. The major part of the debate is reported at 115 Cong. Rec. 37197-204, Dec. 5, 1969, the vote at *id.* 37204-5.

<sup>63</sup>To avoid poaching on territory to be dealt with by subsequent papers, throughout this section I refer to "private foundations" as that category had been generally understood for purposes of the 1950 Act, the 1964 Act, the Treasury Report, and — in 1969 — the 1969 Act. Significant differences appeared in the course of that legislative evolution, but they are not relevant here. It is important, though, to stop the clock with the 1969 understanding of the unadorned statutory definition in the 1969 Act, before the considerable elaboration of exceptions to that definition emerged from subsequent regulations and other interpretations (with the consequent moving of at least some organizations from private foundation to public charity status). By "public charities," of course, I mean all section 501(c)(3) organizations (other than those "testing for public safety") not included in the understanding of "private foundations" I have outlined.

## 2. Grounds: Congressional Experience

Why? An important reason was empirical. Secretary Snyder's statements to the Ways and Means and Finance Committees in 1950 disclose that even then Treasury had found evidence of insider dealings, accumulations, and family business contribution problems among private foundations that was sufficiently broad and of sufficient concern to warrant congressional attention. The subsequent actions of the Ways and Means Committee, the Finance Committee, and the Conference Committee indicate that, in varying degrees, Congress shared that judgment.

Again, by 1964 the Senate Finance Committee had evidence about foundation practices which, though hardly statistically valid, generated serious concerns about foundations in the committee and were sufficiently persuasive in conference to bring agreement with the special Finance Committee limitations on foundation recipients of unlimited charitable contributions. When both the Finance and Ways and Means Committees requested and received the Treasury Report, they had far more broadly based evidence of abuses of roughly the same variety they had begun to find in 1950 — serious where they were present but, I hasten to add, present among only a minority of the foundation field.

Hence, when the congressional tax-writing committees approved the special legislative restrictions for private foundations in 1969, they were — in the main at least — responding to the special foundation evidence before them. It is certainly true that the response was harsher than the evidence justified, but even that harshness resulted from factors peculiar to the foundation field: the misuse of foundations continually broadening through the 1950s and the 1960s; the increasingly adverse publicity generated by the misuses (Patman and the rest); and a natural, if irrational, reaction against foundations growing through the 1969 Ways and Means Committee proceedings.

For public charities, on the other hand, there was no even remotely similar body of evidence of abuses of the sort that were the principal focus of the foundation legislation; and Congress quite naturally did not prescribe the foundation remedies where it found no foundation-like ills.

To complete the picture, one should note that Congress had no congenital aversion to dealing with problems among public charities where it had evidence of them. When in 1950 Congress found that many classes of charities were moving aggressively into unrelated businesses, it applied the unrelated business income tax to all of them (except, of course, churches, which have generally been approached with abundant caution on Capitol Hill). When in 1969 Congress had evidence that a number of charities and other exempt organizations were acquiring businesses (and other income-producing property) in bootstrap and similar debt-financed transactions, it adopted the unrelated debt-financed tax for all categories of organizations involved, this time not stopping even at churches. And, to pick another 1969 example at random, when the extreme advantages of charitable contributions of ordinary income property were brought to its

attention, Congress employed precisely the same remedy for public charities and private foundations.<sup>64</sup>

### 3. Grounds: Conceptual

Further, as Congress confronted the situation in 1969, the distinction between private foundations and public charities made good sense. The very nature of the private foundation made it peculiarly vulnerable to use for personal purposes. Typically established by one individual or family, endowed solely from their funds, and devoted to purposes which they selected, private foundations were likely to be dominated entirely by their donors during the donors' lives and, for at least some substantial period after their deaths, by their families or narrow groups of trusted associates. Their boards frequently consisted of the donors, their attorneys or accountants, and a few close family members or business associates, all of whom were inclined to acquiesce in the donors' judgments about the uses of foundation funds which, after all, the donors had contributed. As a practical matter, subject only to the outside chance of an IRS audit — before 1969, a very outside chance indeed — foundations' operations commonly were carried on from year to year without the knowledge, interest, or intervention of any outside party.<sup>65</sup>

The nature of public charities, on the other hand, was generally quite different. Ordinarily they were controlled by — or, at a minimum, open to the review and intervention of — parties independent of any single donor. That, doubtless, is what Congress had in mind in 1950 when, in adopting the first special restrictions on foundations, it exempted churches, schools, publicly supported charities, and others on the ground that they were “in general what might be called ‘public’ organizations and because of this characteristic are not believed likely to become involved in” the abuses with which the new restrictions dealt.<sup>66</sup>

If they depended for their financial support on public or governmental contributions, at least some contributors of substantial amounts could be expected to have sufficient interest in the charities' affairs to look into what they were doing. The boards of such organizations were ordinarily composed of at least several independent individuals, generally a number of them, and to attract public support they often included individuals with established reputations, known and respected by people interested in the fields of the organizations' charitable work. Even organizations not technically dependent on public financial support for their tax classifi-

cation — churches, colleges, and universities, for example — were subject to the year-in and year-out demands of operating budgets, generally depended upon at least some continuing flow of independent contributions, and knew at some point that they would be subject to the scrutiny of individuals or agencies genuinely concerned with their charitable missions: congregations, vestries, supervisory religious bodies, substantial independent donors, boards of overseers, accreditation agencies, faculties, alumni, and the like.

### 4. Relevance to Self-Dealing, Payout, and Business Holdings

With these major differences between private foundations and public charities went, I should think, solid justification for the 1969 Act's special restrictions on foundation self-dealing, payout failure, and business involvement. The possibility of diversion of charitable assets to donors — substantial where the donor was the only party watching — was far more remote where persons whose focus was the charity's mission constituted its governing body, were its funders, or, at a minimum, were reviewers or observers capable of taking practical steps aimed at preventing or rectifying the diversion.<sup>67</sup> The chance of assets lying unused for charitable purposes was much less where expenditures had to be made for continuing charitable operations and where independent boards were responsible for making them or were subject to review powers of the sort described. The likelihood that a substantial business holding would be productive of aggravated abuse and strikingly unproductive for charity — the latter particularly remarkable in the Treasury survey of foundation business holdings — was much smaller where independent parties controlled the charitable enterprise or possessed such review powers.<sup>68</sup>

<sup>67</sup>The powers of reviewers or observers over the governance of public charities varied considerably among such groups as those listed in the final sentence of the preceding section and the multitude of analogous groups that participated in the affairs of public charities. Virtually all, however, had the ability to secure essential information about the operations of the charities in which they were involved, and at least most had the capacity to exercise substantial practical influence over governance matters that concerned them. While they are post-1969 proceedings, the widely reported Adelphi University and Bishop Estate cases illustrate the power of faculties, alumni, and similar groups to bring alleged abuses to the attention of governmental authorities having the power to correct them. *The Committee to Save Adelphi, et al. v. Diamandopoulos, et al.* slp op. (Bd. of Regents of SUNY, Feb. 5, 1997); Daysog, “Then There Were None: Kamehameha Supporters Embrace the Chance for Reform and Healing,” *Honolulu Star Bulletin* (May 8, 1999); “The State Acts to Remove Bishop Estate's Trustees: A Look at the Issues,” *Honolulu Star Bulletin*, (September 10, 1998); Attorney General's Response to Master's Consolidated Report on the 109th, 110th, and 111th Annual Accounts, *Honolulu Star Bulletin* (September 10, 1998).

<sup>68</sup>For private foundations, the theoretical possibility of abuse did not, as Treasury pointed out in 1965, produce actual abuses among more than a minority of foundations. The lumping-together of all private foundations in 1969 resulted from the fact that the common characteristics of all made it impossible (or, at least, not apparent to Treasury in 1965 or Congress in 1969) to frame a workable general distinction between those which were free from abuse from those which were not. Where the particular nature of the charitable payout concern made distinction feasible, Treasury and Congress adopted it (with the separation of operating and pass-through foundations from other private foundations).

<sup>64</sup>Section 170(e)(1)(A).

<sup>65</sup>While the characteristics of foundations noted in this paragraph are stated in terms of those created by individuals, they applied equally to those established by corporations, a growing subset of the foundation field by 1969. E.g., Sugarman, *Foundations Established for Corporate Giving*, 14th Annual New York University Institute on Federal Taxation 77 (1956). The points stated about board composition and public disclosure of finances and activities were often not true of long-established, matured organizations, such as the Carnegie Corporation and the Rockefeller Foundation; but with the flood of foundations created in the 1940s, 50s, and 60s, by 1969 the Carnegies and Rockefellers surely, in number, made up a quite small proportion of the total foundation universe.

<sup>66</sup>Footnote 13, *supra*.

The governance characteristics of public charities did not, of course, afford absolute protection against direct or indirect personal use of their charitable funds. There plainly are situations in which members of a public charity board attend less carefully to the charity's affairs than the statutory or common law of charities requires, and there are even rare situations in which the members of such a board appear to have joined in abuse of their responsibilities. Situations at least of the former kind had doubtless occurred before 1969, though very few had led to abuses which had come to the attention of Congress or Treasury.

But for present purposes the key conceptual difference between private foundations and public charities before 1969 lay in the differences of their essential natures. Open to creation and domination by one donor or one family and, after the death of an individual donor, subject to no requirement that its governing board ever include any independent party, the private foundation was uniquely suited to the personal, non-charitable uses manifested in the self-dealing, payout failure, and business holdings abuses. Public charities, by contrast, possessed inherent checks against such abuses flowing from their control by parties independent of any one donor or, at a minimum, review and possible action by such parties along the lines outlined above. The checks would fail to work from time to time, and some public charities were undoubtedly in fact controlled by one individual; but among public charities such cases were not the norm.<sup>69</sup> Among private foundations, on the other hand, domination by a single person was exceedingly common.

To put the point somewhat differently, the fact that public charities were open to review and action by independent parties made those who contemplated personal use of charitable assets reluctant to resort to them. No one in the 1950s and 1960s made a practice of recommending the creation of colleges, churches, or, say, local YMCAs or YWCAs as a desirable means of "keeping control of wealth, even while the wealth itself is given away," after the fashion of the 1960 *Business Week* article.<sup>70</sup> For private foundations, recommendations of this sort were widespread and repeated relentlessly; and those who followed them generally got what they wanted as long as the law remained in its pre-1969 state.

### 5. Relevance to Tax and Reduction of Capital Gain Contribution Deduction

On the other hand, it has been apparent for more than two decades that the distinction between private foundations and public charities has nothing whatever to do with the tax on foundation income. The tax has no rational basis for founda-

<sup>69</sup>It is worth noting that, even where the public control and review checks failed to prevent abuse, they made it likely that the abuse would, sooner or later, be discovered and corrected. The *Adelphi* case surely illustrates this proposition, and while proceedings continue in the *Bishop Estate* case, some judicial findings of malfeasance have already occurred. Daysog, "Then There Were None: Kamehameha Supporters Embrace the Chance for Reform and Healing," *Honolulu Star Bulletin* (May 8, 1999).

<sup>70</sup>Footnote 15 *supra*.

tions, and it would have none for public charities. While it has been reduced for foundations from the 1969 House-passed 7-1/2 percent rate to 2 or 1 percent under present law, it should be abolished as soon as it conveniently can.<sup>71</sup>

The reduction of the deduction for contributions of capital gain property to private foundations,<sup>72</sup> when piled atop the 1969 measures framed to excise all foundation abuses of which Congress was then aware, had but thin justification even in 1969. With the broadscale and intensive IRS audits of foundations in the 1970s and 1980s, the repeated Congressional reviews of them in those periods, and the finding of remarkably broadscale compliance with the 1969 rules without finding of any new malfeasance, the justification has thinned almost to imperceptibility.

### 6. Program Restrictions

The limitation on foundation lobbying in 1969 rested on no stated ground not equally applicable to public charities. Nonetheless, Congress has since adopted a major liberalization of the rules for public charity lobbying,<sup>73</sup> taking pains as it did so to point out that the liberalization was not to apply to private foundations; and it seems highly unlikely that any significant broadening of foundations' latitude for influencing legislation will occur in the foreseeable future.

The special restrictions on foundation participation in political campaigns and support of voter registration arose from specific examples presented to the Ways and Means Committee in 1969 and, hence, did not in themselves point to similar restrictions on public charities. In 1987, however, the Ways and Means Subcommittee on Oversight found illustrations of campaign intervention by several public charities, and Congress adopted rules on the subject extending to all section 501(c)(3) organizations.<sup>74</sup> The plethora of subsequent developments concerning campaign activities among both profit and nonprofit organizations strongly suggests that any foreseeable legislation on these issues will hardly be governed by the 1969 differentiation of private foundations from public charities.

The rules for foundation grants to individuals and organizations requiring expenditure responsibility stemmed from the Ways and Means Committee's discovery of an exceed-

<sup>71</sup>The 1998 repeal of the earmarking provision for the tax strengthens the case for abolition even further. Footnote 55 and Committee Reports cited there. For a number of years, though, the EP/EO operations of the IRS have been drastically underfunded. McGovern and Brand, EP/EO — "One of the Most Innovative and Efficient Functions Within the IRS," 76 *Tax Notes* 1099 (1997), sets out an excellent statement of the problem, though emphasizing the Employee Plans aspect of it. The Committee Reports accompanying repeal of the earmarking provision point up the need for adequate funding of the EP/EO activities (Committee Reports cited in footnote 55), and I strongly hope that the Appropriations Committees will attend to their advice.

<sup>72</sup>Section 170(e)(1)(B)(ii), not applicable to operating or pass-through foundations.

<sup>73</sup>Sections 501(h) and 4911.

<sup>74</sup>Section 4955.

ingly small set of cases, and their application to the foundation field as a whole in 1969 could be justified only by the pervasive Congressional distrust of narrowly based private charities. Their extension to public charities would, one would surmise, take place only if Congress had grounds for similar distrust of some subset of those organizations.

The penalty tax on noncharitable expenditures stemmed only from a desire to have, for such expenditures, a tool more precise than that extant under the ambiguous but surely generous scope permitted such expenditures by the courts' and the IRS's interpretation of the statutory requirement that tax-qualified charities be organized and operated "exclusively" for charitable purposes. Analogous provisions have already been applied to public charities' lobbying expenditures and excess benefit transactions,<sup>75</sup> and one can expect the same device to be employed if Congress finds a substantial pattern of noncharitable activity among public charities beyond excess benefit transactions.

## IX. Conclusion

The fundamental problems which drove the central strictures of the 1969 private foundation legislation — self-dealing, payout failure, and adverse consequences of business holdings — began in the 1940s and, by 1950, had already become sufficiently apparent to draw Treasury corrective recommendations and Congressional action. During the 1950s and 1960s they became increasingly serious and considerably more widespread. By the 1960s they — and the broadening notoriety of the foundation as an effective and pliant device for tax avoidance — were giving rise to demands for remedies far harsher than the 1969 law proved to be. Had Congress not dealt with them in 1969, they almost certainly would have continued to blacken the Congressional and public perception of foundations, and they could hardly have failed to precipitate legislative reaction — quite probably more severe the longer it was deferred.

Short of that consequence, the persistence of the problems for almost two decades after Congress first looked into them and attempted to cope with them produced a substratum of congressional mistrust of foundations, first appearing with the 1961 announcement of the Patman investigations but, much more seriously, showing itself in the tax-writing committees in 1963 and 1964, and bursting into full flower in the 1969 Ways and Means Committee proceedings.

The 1965 Treasury Report stated a powerful case in favor of foundations, but the combination of the positive Treasury findings even with the panoply of anti-abuse measures of the 1969 legislation was insufficient fully to overcome the congressional hostility to foundations which had developed by 1969. The consequence was legislation with three aspects: cures for the major ills which Treasury had pointed up; measures extending well beyond any specifically demon-

strated foundation abuses; and a potpourri of provisions dealing with particular problems which came to light in the course of the Ways and Means Committee proceedings.

In assessing this history, though, one misses an essential point if one neglects the Senate's decisive rejection of the proposed limits on foundation lives or fundamental tax benefits. The limit on lives had been urged strongly and vociferously by Congressman Patman for a number of years. It was the subject of much discussion by 1964; it was supported ably by Senator Gore; it was rejected by the Senate Finance Committee in favor of a compromise limit on foundation tax exemptions and deductions; and the latter, less severe proposal received real and robust debate on the Senate floor in 1969. Treasury had rejected the proposed limit on lives in its 1965 Report, fundamentally on the grounds of the unique values foundations brought to modern society. That 69 Senators rejected even the less stringent limit on tax benefits in 1969 — at the height of congressional fervor over foundation misdeeds — was a convincing affirmation of the same judgment. In the three decades since 1969, the membership of Congress has changed many times over, and administrations have come and gone; but that essential evaluation of private foundations has never since been the subject of serious challenge in either Congress or an administration.

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<sup>75</sup>Section 4911(a) (for organizations that elect the liberalized 1976 lobbying rules) and section 4912(a) (for organizations that do not); section 4958 (excess benefit transactions).