3-9-1967

Analysis of the Treasury Department Report on Private Foundations

American Institute of Certified Public Accountants. Committee on Federal Taxation

TAX COMMITTEE COMMENTS AND RECOMMENDATIONS

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on Private Foundations

March 9, 1967

Part of a Special Series Published by
The American Institute of Certified Public Accountants

C O N T E N T S

COMMITTEE ON FEDERAL TAXATION

of the

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Analysis of the Treasury Department Report on Private Foundations

The committee on federal taxation of the American Institute of Certified Public Accountants has studied the Treasury Department Report on Private Foundations issued in February 1965.

The Treasury is to be complimented for preparing a comprehensive report on the activities of private foundations. However, in our opinion, the legislation recommended as a cure for the alleged abuses goes beyond what is required to eliminate such abuses.

We believe that corrective changes may be desirable, but not to the extent recommended by the Treasury. In this context, we respectfully submit the committee's analysis of the Treasury's recommendations.

The Treasury Report, in keeping with the Congressional requests, is limited to private foundations but specifically withholds judgment upon whether similar problems exist and whether similar solutions are needed in the case of other classes of exempt organizations. For purposes of the Report, the term "private foundations" designates essentially all privately supported organizations of the type granted exemption by section 501(c)(3) except those eligible for the 30 percent limitation on charitable contribution deductions.

The Report finds that private foundations play a vital role in our society. It asserts that there is no factual basis for the charge that foundations are becoming a dangerously large segment of our national economy. It finds that the foundations themselves are meeting the charge that they represent dangerous concentrations of economic and social power.

Nevertheless, the Treasury asserts that there exist six categories of major problems, as follows:

1. Self-dealing;
2. Delay in benefits to charity;
3. Foundation involvement in business;
4. Family use of foundations to control corporate and other property;
5. Financial transactions unrelated to charitable functions; and
6. Broadening of foundation management .

1. SELF-DEALING

Existing law prohibits self-dealing except at arm's length. As the Treasury Report points out, this position was adopted in conference on the Revenue Act of 1950 after the House of Representatives had passed a bill barring certain types of self-dealing *per se* and limiting others. The Treasury now recommends a position even more rigid than the House view in 1950. Virtually *all* self-dealing would be banned; but, more than that, the definition of parties related to the donor would be expanded to include corporations in which the donor and members of his family own 20 percent or more of the stock, as well as directors, officers, and persons who hold 20 percent or more of the stock of a corporation which is a substantial contributor to the foundation.

While the Treasury cites certain subtle consequences of the existing situation, such as discrimination between taxpayers and the adverse affect upon taxpayer morale, it is quite candid in disclosing its desire to avoid the administrative burden of the arm's length test. Does this mean that it will in the future propose a ban on transactions between related taxable corporations so that it will be free of the burden of administering section 482?

The Treasury argues that its suggested rules simply introduce into the tax law the concept which is fundamental to the law of private trusts; are consistent with recent tax provisions applicable to pension trusts established by self-employed taxpayers and private foundations eligible to receive "unlimited contributions"; would deprive society as a whole of little, if anything.

The first point to be made is that the House bill of 1950 would have imposed an absolute ban only on loans to substantial donors or to any of its officers or trustees, or any member of their families or to a corporation controlled by them The House bill did not affect sales to or by the foundation which did not involve a substantial part of the foundation's assets. It imposed only an arm's length test on services rendered to or by the foundation. Nevertheless, the Senate found these provisions to be "unduly harsh in their application" and expressed the opinion that "no objection is seen to engaging in transactions with donors if these transactions are carried out at arm's length." The conferees preferred the Senate view.

The second point to be made is that the current Treasury proposals are consistent with the trend of tax legislation since 1950 only in that they are more stringent than ever before. It is true that the nature of the proposed prohibited transactions parallel those of section 503(j), dealing with pension trusts established by self-employed taxpayers. However, section 170(g)(4), dealing with private foundations eligible to receive "unlimited contributions," permits some sales to or by the foundation and both sections employ a 50 percent or more test for control -- not a 20 percent test. Moreover, both pension plans for the self-employed and the unlimited charitable deduction tend to approach the "outer limits" of statutory deductions where one might expect more rigid rules than would be appropriate in circumstances of more general application.

Insofar as the law applicable to private trusts is concerned, we understand that so-called "self-dealing" can occur with the permission of the beneficiaries or of the courts. The Treasury proposal, therefore, would be much more inflexible than the law affecting private trusts.

It may well be that society as a whole would not suffer from a general ban on self-dealing. We submit that this is speculative and that such speculation should not be the basis for such a radical departure from tax rules of long-standing.

The Congress would be justified in imposing a ban on all loans by a foundation to a donor, any member of his family, or to any of the other related parties or entities described in section 170(g)(4). There appears to be no necessity for such loans nor any benefit to be derived by charity from them.

With respect to purchases from and leases to donor-related persons, it might be appropriate to limit their scope along the lines of the House bill of 1950. If the Internal Revenue Service now finds the term "substantial" too vague to administer, the ban might extend to transactions involving more than 25 percent of the assets of the foundation.

In all other respects the arm's length test imposed by section 503(c) is adequate and fair. We are confident that the Service has the will and the capability to enforce it.

2. DELAY IN BENEFIT TO CHARITY

Existing law deprives a foundation of its exemption for any year in which its accumulated income is (1) unreasonable in amount or duration, (2) used to a substantial degree for non-exempt purposes, or (3) invested in such a manner as to jeopardize the carrying out of the organization's exempt functions. These rules also evolved in 1950, at which time the House preferred to tax all income in excess of one year's investment income which was not distributed currently or placed in a special purpose 5-year trust fund.

Despite the fact that such subjective terms as "reasonable" and "substantial" are used frequently in the Internal Revenue Code and in the Regulations and have been dealt with by Revenue Agents for years, the Treasury now finds them, in the private foundation area, to be "inadequate as well as difficult and expensive to administer."

But the Treasury is not content merely to propose that a non-operating foundation be required to distribute the full amount of its current income by the end of the year following the year in which it is earned (with the exception of funds earmarked for a specific purpose). It now advances the entirely novel concept of a required minimum annual distribution to charity irrespective of the foundation's actual income. This minimum level of charitable expenditures, described as the "income equivalent," would be prescribed annually by the Secretary of the Treasury by reference to the yield on investment funds held by such organizations as universities. Based upon then existing market conditions, the Report estimated that a reasonable "income equivalent" would be in the range of 3 to 3½ percent. This rate would be applied to the fair market value of the foundation's investment assets. If the actual yield was less, the organization would have to distribute corpus to make up the difference.

It seems incongruous that the Treasury, after protesting the difficulty and expense of administering existing law, would make such a proposal as this. Table 12 appearing at page 87 of the Report shows that 57 percent of foundations had ordinary income which was less than 3 percent of market net worth, arrayed as follows:

Donor-Related Control	
20 percent or less	45%
More than 20 percent	59%
More than 50 percent	59%

Thus, not only is the Treasury proposing an administrative task of great magnitude for both the Service and for foundation officials (e.g., the income equivalent would not be applied against assets with respect to which the donor's deduction would be postponed by reason of other recommendations in the Report), but we question whether significant evidence has been adduced justifying the adoption of this radical concept.

There is no reason for objecting to a requirement for reasonably prompt distribution of current income coupled with the exceptions proposed by the Treasury. We recommend the adoption of an additional exception extending the required distribution period for income set aside for a specific non-charitable purpose such as a lawsuit or a tax proceeding, or for establishing certain necessary reserves as provided under generally accepted accounting principles.

It would also seem desirable to provide for deficiency distributions to protect against the consequences of inadvertent failure to distribute the net income within a certain time, particularly in cases where such income is increased as the result of a redetermination by the IRS. The term "realized income" should be precisely defined as being net income as determined under Chapter 1 of the Internal Revenue Code, excluding long-term capital gains, excluding the excess of percentage depletion over cost depletion, and eliminating the special deductions for corporations granted under sections 241 to 247 of the Code.

Finally, for purposes of allowable deductions for depreciation, depletion and amortization it would seem appropriate that the basis of contributed property should be its fair market value at the date contributed to the foundation.

3. FOUNDATION INVOLVEMENT IN BUSINESS

The Treasury Department Report alleges that the following serious difficulties arise from foundation commitment to business endeavors:

a. Regular business enterprise may suffer serious competitive disadvantage.

b. Opportunities for self-dealing proliferate.

c. Foundation management may be drawn from concern with charitable activities to time-consuming concentration on the affairs and problems of the commercial enterprises.

Concluding that foundations have no real need to "engage in business" and that "business participation" is altogether inappropriate for private foundations, the Treasury proposes a prohibition on a private foundation owning, either directly or through stock holding, 20 percent or more of a business unrelated to the charitable activities of the foundation.

The Congress dealt with these problems in 1950 when it removed the immunity formerly enjoyed by "feeder" organizations and imposed a tax on the unrelated business income of foundations. The Treasury complains that existing law still permits taxable corporations unaffiliated with foundations to be placed at a competitive disadvantage as the result of the following:

a. Foundations are able to lease business assets owned free of debt to operating subsidiaries, siphon off most or all of the business profits by means of rent which is deductible by the subsidiary but not taxable to the parent foundation, and thereby accumulate large reservoirs of untaxed capital which can be used to support the future operations of the business.

b. Because contributions to foundations may be deducted by the contributors for Federal income tax purposes, the capitalization of foundation businesses is accomplished with tax-free dollars rather than after-tax dollars.

c. The tax immunity of dividends, interest, and other proceeds stemming from passive sources enables foundations to supply capital to their business endeavors with exempt income.

d. A remarkable number of foundation-owned enterprises proceed from year to year realizing substantial profits, but making negligible or no distributions to their parent organizations, thereby improving their competitive posture through modernization and expansion.

e. A number of foundations have revealed a willingness to commit charitable funds to business operations which are failing or, at least, producing consistent losses.

Assuming, _arguendo_, that each of these situations exists in undesirable proportions, we submit that they can be dealt with adequately without "burning the house to cook the pig."

There is no abuse _per se_ when a foundation leases business assets to an operating subsidiary. If the rent paid is excessive, the Internal Revenue Service has ample authority under Code section 482 to correct the situation.

If abuses arise from the exemption from the unrelated business income tax applicable to rents from leases whose term is not longer than five years and from personal property leased with realty, then these exemptions should be eliminated.

If it is considered undesirable to have business capitalized with tax-free dollars, then foundations should be prohibited from organizing, purchasing a controlling interest in, lending money to, or contributing capital to an unrelated business enterprise.

If it is considered undesirable for foundation-owned enterprises to accumulate earnings without limitation, then Code section 532 should be amended to subject such corporate enterprises to the accumulated earnings tax without regard to the intent to avoid income tax.

We are not suggesting that all of the above-described changes in our tax laws are necessary or desirable. The point simply is that specific problems should be met by equally specific solutions and not by the flat prohibition on ownership by the private foundation of 20 percent or more of an unrelated business.

In any event, we submit that the restriction to 20 percent ownership is too severe (anything less than 50 percent should be sufficient) and that its retroactivity can create severe hardships and potential loss of benefit to charity as the result of forced dispositions.

We are aware of Congressman Patman's view that foundations should be limited to ownership of no more than 3 percent of the stock of a corporation and should not be allowed to vote such stock. While the Treasury's proposal is reasonable by comparison, we are not persuaded that the Congress will enact such arbitrary legislation without the presentation of more convincing evidence of widespread and otherwise unpreventable abuse.

4. <u>FAMILY USE OF FOUNDATIONS TO CONTROL CORPORATE AND OTHER PROPERTY</u>

This question also was considered at length when the Revenue Act of 1950 was passed. At that time the House bill would have denied a charitable deduction for income, estate and gift tax purposes if <u>both</u> of the following conditions were present:

a. The contributor, or members of his family, had voting control of the organization to which the gift was made, <u>and</u>

b. The contribution consisted of stock in a corporation in which the donor, together with members of his family and controlled tax-exempt organizations, controlled 50 percent or more of the voting stock or 50 percent or more of the total stock.

The Senate rejected this provision for the expressed reason that greater funds would be lost to charity than were involved in tax avoidance.

The Treasury Department Report alleges that the following problems arise from family use of foundations to control corporate and other property:

a. Because of the donor's retention of control over the dividend distribution policy of the corporation, the benefits which charity ought to receive from the contribution of stock are frequently deferred indefinitely or absent altogether.

b. By arranging redemption of token amounts of the stock or by causing an atypical, but strategically timed, dividend distribution the donor may be able to sustain his claim that the stock has substantial value and entitles him to a large deduction on its contribution to the foundation.

c. When the corporation encounters financial difficulties, the donor's duty to the foundation may run counter to his obligation to the other shareholders or to his own self-interest.

d. In closely-held corporations the salary levels of family members will be fixed as high as is consistent with the tax law's concept of reasonableness, whereas the interest of the foundation lies in keeping salaries as low as is consonant with the employment of competent personnel.

e. The donor may be tempted to have the foundation retain its funds to meet the possible future needs of the business instead of expending them for charitable purposes.

The Treasury Department admits that the so-called abuses generated by family dominion over foundation property are similar to those for which separate solutions were proposed in other portions of its Report. Nevertheless, the Treasury proposes to deny an income tax deduction for a gift, in cases where the donor and related parties own 20 percent or more of the voting power of a corporation or a 20 percent or more interest in an unincorporated business or other property, until (a) the foundation disposes of the contributed asset, (b) the foundation devotes the property to active charitable operations, or (c) donor control over the business or property terminates. An interest owned by the foundation would be attributed to the donor but the presumption that a 20 percent interest constitutes control could be rebutted.

However, the Treasury suggests that the Congress might consider an alternative solution to the alleged problems, i.e., a postponment of the donor's deduction only where he and related parties exercise substantial influence over the foundation to which the contributions are made. The Treasury then hedges this alternative proposal by asserting that retention of donor control over a corporation whose stock is being contributed makes the real value of what has passed to the foundation subject to the continuing volition of the donor even where such donor exercises no substantial influence over the foundation.

There may be a conflict of interest in some situations where stock of a closely-held corporation is donated to a private foundation. But this situation generally does not exist in a 20 percent ownership situation. Even if a 20 percent interest constitutes effective control, there is not necessarily any more conflict of interest between the donor and the foundation than between the donor and the other shareholders.

We believe, as did the Senate in 1950, that the loss to charity which will result from this approach will exceed any tax avoidance which may be eliminated. Elimination or extended deferral of income and estate tax deductions in the instances indicated will not only remove a factor which encourages contributions, but will also eliminate the ability of some individuals, such as businessmen who own little of value outside of their business interest, to make contributions.

Tables 10 and 11 (on pages 79 and 83) of the Report disclose that the Treasury's proposal could affect 8 out of every 10 foundations in existence. Of more importance, these tables show that the performance of foundations with more than 20 percent donor-related influence over investment policy is generally just as good as that of foundations with a lesser degree of control. The following are some relevant ratios.

	Percent of Donor-Related Influence over Investment		
	Not over 20 percent	Over 20 percent	Over 50 percent
Ratio of market value of net assets to book value	144%	141%	132%
Ratio of ordinary income to market value of net assets	4.0	3.5	3.5
Ratio of contributions received to market value of net assets	3.1	7.7	9.8
Ratio of grants made to market value of net assets	6.0	6.9	7.9
Ratio of grants made to ordinary income	151	197	222

We suggest that the Treasury has failed to make a case for the drastic proposal which it advances.

5. FINANCIAL TRANSACTIONS UNRELATED TO CHARITABLE FUNCTIONS

The Treasury Department Report ooncludes that private foundations, by engaging in three types of financial transactions unrelated to their charitable functions, can produce seriously unfortunate results. These types of transactions are:

a. Borrowing funds for purposes unrelated to the charitable purpose;

b. Lending funds on an unsecured basis; and

c. Engaging in trading and speculation.

The solution recommended would invoke an absolute ban on borrowing for investment purposes and on speculation, specifically including puts, calls, short sales, trading in commodity futures, and the like. Loans which the Report describes as meeting this criterion are securities of a type regularly traded upon an exchange or in an over-the-counter market, loans to governmental units, loans secured by first mortgages on real estate, loans to students, and short-term loans represented by the marketable commercial paper of prime borrowers. The Secretary of the Treasury would prescribe by regulations other loans of "substantially similar quality and character."

The evils which the Treasury perceives in borrowing by foundations for investment purposes are:

a. Private parties are able to shift a substantial measure of the financial benefit of the foundation's tax exemption to themselves (the so-called "bootstrap" sale); and

b. The private foundation can convert its tax exemption into a self-sufficient device for the production of capital, thereby severing itself from reliance upon contributions and eliminating the healthful scrutiny of its activites which is implicit in such reliance.

The Congress considered this matter at length in 1950 and, more recently, in the form of H.R. 15942, a bill which was drafted for the stated intention of dealing with the Supreme Court's decision in Clay B. Brown. Actually, this bill went significantly beyond what is necessary to deal with the "bootstrap" sale to charity. It embraced the entirely new concept that virtually *any* type of income derived by an exempt organization, public or private, from the use of borrowed funds shall be taxed differently than the same or similar income derived from the use of corpus. While the bill went too far, it was vastly superior to a flat prohibition of foundation borrowing. We believe that the corrective measures need not extend beyond:

a. Taxing as ordinary income the extent to which the amount realized from a sale to an exempt organization exceeds the fair market value of the property sold; and

b. Taxing as unrelated business income all rents derived from the leasing of personal property with the exception of incidental and insubstantial personalty leased with real property.

We believe that present law contains adequate safeguards with respect to lending by foundations. Nevertheless, as stated previously herein, we see no objection to a prohibition against loans to the donor or donor-related parties. It also seems appropriate to bar speculation.

6. BROADENING OF FOUNDATION MANAGEMENT

The Patman Report recommended that the life of foundations be limited to 25 years. While not agreeing with this conclusion, the Treasury Department Report recommends that private foundations be required after that length of time to convert to management which is independent of their donors and donor-related parties.

The Treasury admits that the so-called problems in this area "evade precise definition and quantitative analysis." Its rationalization of this proposal seems to embrace the concept that once a tax deduction is allowed for a contribution, the money or property somehow becomes transmuted into public funds which the public has a present, or at least a latent, right to administer. It is lamented that many foundations continue in existence year after year without achieving "any of the external indica of unique advancement of philanthropy."

It has been argued -- and with considerable validity -- that an exempt organization should serve the public interest in essentially the same fashion as when public funds are properly expended. Accepting this philosophy, for the sake of argument, one must still recognize that the public interest is an ephemeral concept. We are certain that Congressman Patman's ideas on the proper expenditure of public funds are poles apart from those of his colleague, Senator Tower. Who, then, are these "persons more broadly representative of the public" to whom the Treasury would turn over control of every private foundation after 25 years. What, specifically is the "parochialism" that needs to be combatted?

If there are abuses of sufficient magnitude to vitiate the fulfillment of an organization's exempt purpose, it would appear that adequate remedy exists under present law through denial of exemption. If what we are really discussing is a difference in social predilections, then we submit that these should not be controlled through the medium of the tax laws.

7. <u>ADDITIONAL PROBLEMS</u>

Three additional problems are discussed in the Treasury Department Report, as follows:

a. Contributions of unproductive property;
b. Contributions of section 306 stock and other ordinary income assets; and
c. Correction of the computation of the estate tax marital deduction.

The Treasury proposes to defer an income tax deduction for a contribution of property which is unproductive of income until the asset is (a) made productive, (b) disposed of, or (c) applied to charitable uses. Despite its previously indicated anathema toward such terms, the Report goes on to state that "an asset will be considered unproductive unless <u>substantial</u> income is <u>regularly</u> derived from it." (Emphasis supplied.)

As in the case of the earlier discussion of the proposed treatment of so-called controlled property, we submit that the Treasury has failed to make a case for this drastic proposal.

The Treasury proposes that the income tax deduction accorded for the gift of any asset to a private foundation be reduced by the amount of any ordinary income which the donor would have realized if he had sold the asset for fair market value at the time of the contribution.

In support of this radical proposal the Treasury appears to rely primarily on the "problem" in connection with section 306 stock. The only argument advanced for including other ordinary income assets is that by contributing such assets the donor escapes taxation and at the same time reduces the amount of his other taxable income, thereby creating situations where the donor can make more profit by giving the asset to a foundation than he would be able to retain if he had sold it.

The Treasury states that the recent Congressional action on the ordinary income situations arising under sections 1245 and 1250 is directly relevant here. It is true that section 170(e) provides the same rule for contributions of section 1245 or section 1250 property as the Treasury now proposes for all ordinary income assets. However, this Treasury effort to extend the rule of sections 1245 and 1250 to other assets ignores the purpose of these sections. Sections 1245 and 1250 deal with deductions previously taken by the taxpayers. They were intended to "make it feasible for the Treasury to adopt more liberal rules with respect to the estimated useful life of depreciable assets." They do so by ensuring that depreciation deductions previously taken will ultimately be returned as ordinary income, directly or indirectly, to the extent the deductions are not validated by a decline in the fair market value of the respective asset. No such considerations apply to contributions of other property as no deductions will previously have been taken by the taxpayer with respect to such property.

Neither is the situation with respect to stock in collapsible corporations nearly so clear as the Report indicates. Suppose that the corporation is not in fact collapsed and that section 341 has ceased to be applicable before the foundation disposes of its stock. Would the Treasury nevertheless treat the charitable gift as the equivalent of a sale or exchange for the purpose of applying section 341? This situation is different from "section 1245 property" which never ceases to be such.

Finally, it certainly seems impractical and particularly unwise to further expand section 170(e) to cover gifts of inventory items. There is no demonstrated abuse, and thousands of small taxpayers would be affected by such a change.

The Treasury recommends that, where a donor secures an income tax deduction for the transfer of an interest in property to a foundation, the value of such property should be excluded from the base upon which his estate tax marital deduction is computed. This proposal would remove the existing distinction between contributions to controlled and uncontrolled foundations. It appears to be entirely appropriate.