[JOINT COMMITTEE PRINT]

DESCRIPTION OF INCOME TAX PROVISIONS RELATING TO PRIVATE FOUNDATIONS

SCHEDULED FOR HEARINGS

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

ON

JUNE 27, 28, AND 30, 1983

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

In general

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled public hearings on June 27, 28, and 30, 1983, on the Federal tax rules applicable to private foundations. In a press release on the hearings, the Subcommittee stated that the hearings are intended to develop information to assist in determining whether the foundation rules enacted in the Tax Reform Act of 1969, "without imposing unnecessary or unduly burdensome restrictions, ensure that only those private foundations operating for the public benefit enjoy favorable tax treatment."

This pamphlet, prepared in connection with the hearings, contains descriptions of the provisions of Federal tax law relating specifically to private foundations (as compared to tax provisions generally applicable to all charitable organizations, such as the general requirements for tax-exempt status, the tax on unrelated business taxable income, or the estate tax charitable deduction). The first part of the pamphlet is a summary of the background of the Tax Reform Act of 1969 and of the principal private foundation provisions of present law. This is followed by a more detailed overview of the provisions of present law and the legislative background of those provisions.

Subcommittee framework for discussion

In its press release of May 3, 1983, the Subcommittee on Oversight set forth the following "Framework for Discussion" in connection with the hearings—

I. FOUNDATION PROFILE QUESTIONS

The Subcommittee seeks information on the following general questions:

(A) What role do private foundations play in private philanthropy?

(B) How are private foundations responding to the President's call for increased voluntarism and private sector initiative in light of reduced Federal spending?

(C) What are the sources of funding for private foundations?

(D) What philanthropic activities are private foundations undertaking?

(E) Who are the recipients of the charitable distributions of private foundations?

(F) What are private foundations' payout rates for qualifying charitable distributions?

(G) What types of assets do private foundations have, and what is the rate of return on each type of asset?

(H) What types of investments do private foundations make, and what investment policies guide their decision-making regarding investment selections?

(I) What portion of the qualifying distributions of private foundations represents administrative expenses, particularly trustee compensation?

(J) What has been the effect of the Tax Reform Act of 1969 on the operations, vitality, and growth of private foundations?

(K) Is avoidance of private foundation status a factor that is considered in deciding upon the format for philanthropic activities? If so, why?

(L) What type of public disclosure and accountability are afforded by private foundations, and how helpful is it to potential grantees and to the public in general?

II. ISSUES RELATING TO PRESENT STATUTORY STRUCTURE

In addition, the Subcommittee requests comments on the issues surrounding the rules and regulations governing private foundations, including, but not limited, to the following:

A. Divestiture Requirement for Business Holdings

1. What foundations have divestiture problems with regard to excess business holdings, and why?
2. Are there any circumstances under which relief from the divestiture rules would be appropriate?
3. If such circumstances do exist, what form of relief is warranted?

B. Definitions of Disqualified Persons

1. Are any statutory definitions of disqualified persons unnecessarily stringent or overbroad?
2. If so, how should they be limited?

C. Expenditure Responsibility

1. To what degree are private foundations administratively burdened in exercising expenditure responsibility?
2. To what degree do the expenditure responsibility requirements influence foundations' grant-making decisions?
3. Should the expenditure responsibility requirements be eased, and if so, in what manner?

D. Penalty Taxes

1. Are there circumstances in which the automatic imposition of the first-level penalty taxes is unwarranted?
2. Should the Secretary of the Treasury be authorized to abate the first-level penalties?
3. What type of abatement mechanism could be authorized which would in no way lessen compliance with the rules?

E. Two-Percent Excise Tax

1. Is the collection of the 2-percent tax still in keeping with the purpose for which it was originally intended?
2. How are the revenues raised by this tax being used?

3. To what degree does the 2-percent tax erode the resources that are available for charitable purposes?

F. Declaratory Judgment Procedure

Is the availability of the declaratory judgment procedure too restrictive?

G. Administration of the Statutory Rules by the Internal Revenue Service

1. Is the "10-percent public support" test set forth in the regulations relating to the definition of private foundation too restrictive? Should certain organizations which fail to meet the "10-percent" test nevertheless be excluded from private foundation status?
2. In what ways should the Form 990-PF, Return of Private Foundations, be improved?
3. Should the regulatory restriction on reliance by a private foundation on an IRS ruling as to the public status of a potential grantee be modified? If so, how?

H. Compliance

1. To what extent are private foundations complying with the rules set forth in 1969?
2. Have the 1969 rules succeeded in eliminating the abuses the rules were intended to address?
3. Are there any ways in which the current rules can be so manipulated that an organization may avoid private foundation status and the restrictions that follow such status?

I. Simplification

How can existing law be simplified?

I. SUMMARY OF PRIVATE FOUNDATION RULES

Background of the Tax Reform Act of 1969

The private foundation provisions of the 1969 Tax Reform Act were enacted in light of findings that neither the general requirements for tax-exempt status, nor the specific rules under prior law governing foundation transactions and expenditures, had proved effective to ensure that Federal income tax incentives would be available only where a foundation's assets and income are devoted to charitable, and not private, purposes. Accordingly, since the rationale underlying the deductibility of contributions and tax-exempt status is the encouragement of private giving to carry out charitable programs and activities, the 1969 Act developed additional rules and excise tax sanctions designed to ensure that the expenditures, investments, and transactions of private foundations will be consistent with this underlying rationale for favorable tax treatment.

The lengthy hearings held by the tax-writing committees on the 1969 legislation, the 1965 Treasury report on private foundations, and investigations and hearings conducted from 1962-69 by the House Select Small Business Committee (chaired by Wright Patman) had demonstrated specific instances where prior law had been inadequate to prevent the use of foundations for controlling business enterprises and benefiting substantial contributors at the expense of charitable programs, to prevent foundations from denying current benefits to charity through investments in nonproductive assets, or to prevent foundations from making grants without taking responsibility for proper use of the funds for charitable purposes. Also, the prior-law rules, which included prohibitions on unreasonable accumulations of income, and on transactions with related persons if not made on arms's-length terms, lacked specificity and clarity. Finally, the only sanction under prior law for foundation misuse (loss of exempt status) was so severe that the Internal Revenue Service and the courts hesitated to impose it in all but the most egregious cases.

Rules applicable to foundation expenditures and investments

In the 1969 Tax Reform Act, the Congress enacted a series of rules (violations of which trigger excise taxes) that require private foundations to maintain a specified minimum level of charitable expenditures or grants, that limit the extent to which foundations may control business enterprises, and that prohibit foundations from making speculative investments, from making grants to other foundations without exercising expenditure responsibility, and from engaging in "self-dealing" transactions with related persons. In addition, the 1969 Act imposed an excise tax of 4 percent (reduced to 2 percent in the Revenue Act of 1978) on the net investment income of private foundations, and strengthened prior-law rules for reporting information to the Internal Revenue Service and disclosure to the public.

The 1969 Act generally defined private foundations as all charitable, educational, or religious organizations (including trusts with charitable, etc. beneficiaries) *other than*—

(1) Several categories of organizations which, under prior law, had been eligible for favorable charitable deduction rules. These public charities include certain organizations defined by reference to their nature (such as churches, schools, and hospitals) and others defined by reference to their broad public support or governmental funding (such as the United Givers Fund or publicly supported community centers, museums, libraries, etc.).

(2) An additional category of organizations which receive broad public support in the form of contributions, membership fees, or receipts from admissions, etc. (including publicly supported membership organizations such as PTA associations, scouting groups, etc.).

(3) Organizations formed exclusively to benefit, and which are controlled by or operate in connection with, public charities (such as scholarship trusts operated in connection with a college).

Organizations which fail to qualify under any of these three categories of public charities are classified for tax purposes as either private nonoperating foundations—basically, grantmaking foundations—or as private operating foundations—basically, foundations which themselves directly engage in charitable, etc. functions.

Charitable deduction rules

The 1969 Tax Reform Act also modified prior-law rules governing charitable deductions for contributions by individuals to public charities and private foundations.

In general, the 1969 Act retained differing treatment (dating from the 1954 Code and the Revenue Act of 1964) with respect to the percentage limitations applicable for contributions to public charities as compared to contributions to private nonoperating foundations, but extended the more favorable treatment for public charities to private operating foundations. Also, the 1969 Act generally required a reduction (from fair market value) in the amount deductible on contributions of appreciated capital-gain property to private nonoperating foundations, but not in the case of such contributions to public charities or private operating foundations.

II. DESCRIPTION OF PRIVATE FOUNDATION RULES

A. Tax on Net Investment Income

The Tax Reform Act of 1969 imposed a four-percent excise tax on the net investment income of private foundations, i.e., on the sum of gross investment income (including interest and dividends) plus net capital gain, less expenses of earning such income (Code sec. 4940). The tax was imposed so that foundations would share some of the costs of government, particularly the costs of administering the tax laws relating to exempt organizations. In the Revenue Act of 1978, the Congress reduced the tax rate to two percent, noting that the prior rate had produced more than twice the revenue needed to finance administration by the Internal Revenue Service of the exempt organization provisions of the Code.

B. Sanctions to Enforce Foundation Rules

Overview

The Tax Reform Act of 1969 established a two-tier system of excise taxes intended to ensure compliance with the private foundation rules set forth in Code sections 4941-4945.

These excise tax sanctions were substituted for the principal penalties imposed under prior law for foundation misuse, i.e., loss of the foundation's exempt status and its eligibility to receive deductible contributions. In the case of relatively minor abuses, the prior-law penalties seemed unduly harsh. Moreover, the severity of prior-law penalties resulted in extensive litigation when the Internal Revenue Service sought to impose them in more serious abuse situations, and a noticeable reluctance by the courts to uphold the penalties in any but the most egregious cases.

First-tier sanctions

Under present law, any violation of the foundation rules (secs. 4941-4945) results in imposition of an initial excise tax on the foundation (or in the case of self-dealing, on the disqualified person who entered into the prohibited transaction with the foundation). For example, violation of the prohibitions on self-dealing transactions or jeopardizing investments triggers an excise tax equal to five percent of the amount involved in the self-dealing transaction (sec. 4941) or the jeopardizing investment (sec. 4944), payable for each year (or part thereof) in the taxable period. This means that the tax under section 4941 or 4944 continues to be imposed each year beginning when the prohibited act occurs and ending only when the Internal Revenue Service issues a deficiency notice or assesses tax on the act, or when the prohibited act is "corrected."

In general, the first-tier excise tax on the foundation (or on the disqualified person engaged in self-dealing) applies automatically when a foundation rule is violated, even if the violation in a particular instance could be deemed inadvertent. However, where a foundation fails to satisfy the section 4942 payout requirements solely as a result of an incorrect asset valuation which was due to reasonable cause, the excise tax under that section is excused if the payout deficiency is made up during a specified period.

If there is a violation of the prohibitions on jeopardizing investments, taxable expenditures, or self-dealing, an initial excise tax is imposed on any foundation officer, director, trustee, or responsible employee who knowingly participated in the prohibited act, unless the manager had reasonable cause to excuse participation in the act. This first-level tax on the manager cannot exceed $5,000 ($10,000 in the case of self-dealing) for any one such violation.

Second-tier sanctions

If a violation of the foundation rules (secs. 4941-4945) is not "corrected" within a specified period, an additional excise tax is imposed on the foundation (or in the case of self-dealing, on the disqualified person). For example, a second-tier tax equal to 200 percent of the amount involved in a self-dealing transaction would be imposed on the disqualified person unless (1) the prohibited transaction is undone to the extent possible and (2) the foundation is placed in a financial position not worse than it would be had the disqualified person dealt with the foundation under the highest fiduciary standards.

Similarly, an additional excise tax is imposed on a foundation manager who refuses to agree to correct a violation of the prohibitions on self-dealing, jeopardizing investments, or taxable expenditures. The second-tier tax on the manager cannot exceed $10,000 for any one such violation.

Additional penalties

If a foundation rule violation is willful and flagrant,[1] or if there has been a prior violation of any foundation rule, the excise tax sanctions are doubled, unless the violation was due to reasonable cause (sec. 6684). In addition, a termination tax (sec. 507) may be imposed on the foundation if the violation was willful and flagrant or there have been "willful repeated"[2] violations.

C. Mandatory Payout Rules

Background

Under a provision enacted in the Revenue Act of 1950, certain charitable organizations (generally corresponding to private foundations as defined by the Tax Reform Act of 1969) would lose their tax-exempt status if the organization's aggregate accumulated

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[1] An act or failure to act violating a foundation rule is deemed willful and flagrant if it is "voluntarily, consciously, and knowingly" committed in violation of any said rule and if it "appears to a reasonable man to be a gross violation * * *" (Treas. Regs. sec. 1.507-1(c)(2)). No motive to avoid the foundation restrictions is necessary to make an act or failure to act willful. However, an act or failure to act is not willful if the foundation (or a manager, if applicable) does not know that it is an act to which the foundation rules apply (Treas. Regs. sec. 1.507-1(c)(5)).

[2] For this purpose, the term willful repeated violations means at least two acts or failures to act both of which are "voluntary, conscious, and intentional" (Treas. Regs. sec. 1.507-1(c)(1)).

income was "unreasonable in amount or duration" in order for the organization to carry out its charitable functions.

In substituting the payout rules in the 1969 Act for this prohibition on unreasonable income accumulations, the Congress found that the prior-law restriction had been defective in two respects.[3]

First, the prohibition on unreasonable income accumulations failed to preclude private foundations from holding or investing in assets which produced no current income, such as undeveloped land. As a result, while the donor to the foundation would receive an immediate charitable deduction on making a gift of nonproductive assets (or of property converted into such assets by the foundation), there could be an indefinite delay between the loss of tax revenues from allowing the deduction and the benefit intended to accrue to the public from having an equivalent amount of funds devoted by the donee foundation to charitable programs.

Second, the prohibition on unreasonable income accumulations was difficult to enforce both because of its vagueness and the essentially subjective nature of the test, and because the prior-law sanction (loss of exempt status) was either unduly harsh for minor violations or largely ineffective for more substantial violations. Some court cases under the prior-law restriction had been interpreted as sanctioning accumulations of income for up to 10 years for the sole purpose of increasing the size of the foundation's corpus.[3a]

Present law (Code sec. 4942)

The Tax Reform Act of 1969 in effect required private nonoperating (grantmaking) foundations to make payouts at a specified minimum level, either (1) as direct expenditures to accomplish charitable purposes (including administrative expenses paid for such purposes) or (2) as grants to public charities or private operating foundations. (Grants to private nonoperating foundations generally do not count as qualifying distributions, nor do grants to an organization controlled by the donor foundation or its disqualified persons.) If certain requirements are met (including, in certain cases, advance approval from the Internal Revenue Service), a foundation may count as current distributions amounts "set aside" to be paid within five years for a specific project.

As enacted in 1969, the payout provision required foundations to make qualifying distributions equal to the higher of (1) the foundation's net income (other than long-term capital gains) or (2) the foundation's minimum investment return—then set at six percent of the fair market value of the foundation's investment assets, with that rate subject to certain adjustments for post-1970 years. The Tax Reform Act of 1976 substituted a flat five-percent rate for measuring the minimum investment return. In 1981, the Economic Recovery Tax Act repealed the prior-law rule that had required foundations to distribute any excess of net income over the mini-

[3] See H.R. Rep. No. 91-413 (Pt. 1), 91st Cong., 1st Sess. 25-27 (1969); S. Rep. No. 91-552, 91st Cong., 1st Sess. 34-38 (1969); Staff of the Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1969" 36-40 (Comm. Print 1970) (hereinafter cited as "General Explanation of 1969 Act"); "Treasury Department Report on Private Foundations," House Committee on Ways and Means, 89th Cong., 1st Sess. 23-30, 58-60, 92-96 (Comm. Print 1965) (hereinafter cited as "1965 Treasury Report").

[3a] See 1965 Treasury Report, *supra* N. 3, at 26.

mum investment return, on the ground that because of then high inflation rates, the income distribution requirement could result in significant erosion of the real value of foundation endowments.

Thus, to avoid excise tax under present law, a private nonoperating foundation must make qualifying distributions, by the end of the following year, at least equal to five percent of the value of its investment assets for the year (less the amount of sec. 4940 tax on the foundation's net investment income for the year). Under a special rule, a foundation is excused from the excise tax sanction if insufficient distributions resulted from an incorrect valuation of assets which was due to reasonable cause, and the payout deficiency is made up during a specified period.

The payout rules under section 4942 do not apply to private operating foundations. However, to qualify for operating status, a private foundation must meet certain payout requirements (see Part III-B of this pamphlet).

D. Limitations on Business Holdings

Background

Prior to the Tax Reform Act of 1969, there were no specific provisions that dealt with ownership of businesses by charitable organizations, including private foundations. However, in some cases, the courts held that an organization lost its tax-exempt status where the business activities predominated over the charitable activities of the organization.

In 1969, the Congress found that a number of private foundations were being used to maintain control of businesses. This result was possible because prior law was not sufficiently clear on how much business activity would disqualify an organization from exempt status, and because courts were reluctant to deny exempt status for having such holdings.

In addition, the Congress was concerned that foundations which owned large holdings in a business tended to be relatively unconcerned about producing income, that the attention and interest of such organizations would be devoted to the operation, maintenance, and improvement of the business while neglecting exempt activities, and that businesses owned by exempt organizations may be operated in a way that provides those businesses with a competitive advantage over businesses owned by taxable persons. In general, the Congress concluded that a private foundation should be limited in the amount of a business which it may control.[4]

Present law (Code sec. 4943)

Post-1969 holdings

The Tax Reform Act of 1969 in effect generally limited the combined ownership of a business corporation by a private foundation and disqualified persons (for this purpose, including certain related

[4] See H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 27-31; S. Rep. No. 91-552, *supra* n.3, at 38-45; General Explanation of 1969 Act, *supra* n.3, at 40-46; 1965 Treasury Report, *supra* n.3, at 30-45, 96-99.

foundations) to not more than 20 percent of the voting stock.[5] (For example, if the disqualified person's holdings are five percent, the foundation itself may hold only 15 percent.) If persons other than disqualified persons have effective control of the corporation, the combined foundation/disqualified person holdings are limited to 35 percent. A private foundation may not conduct any business as a proprietorship.

Under a *de minimis* rule, there are no excess business holdings if a private foundation (together with related foundations) owns not more than two percent of the voting stock and not more than two percent of the value of all classes of stock, regardless of the extent of ownership by disqualified persons. Also, there are no percentage limitations on foundation ownership of a business which is functionally related to the foundation's charitable programs, or of a business deriving 95 percent of its gross income from certain passive sources.

Holdings in excess of permitted limits which are acquired after May 26, 1969 by gift or bequest must be disposed of by the foundation within five years after acquisition. Post-May 26, 1969 purchases of stock by a foundation or a disqualified person which create or increase aggregate holdings beyond permitted limits do not qualify for the five-year grace period, and may immediately result in excise tax penalties on the foundation (subject to a 90-day grace period for a foundation to reduce its holdings as required after purchases by a disqualified person). Under a so-called "downward ratchet" rule, if a private foundation must reduce its holdings because of purchases by disqualified persons which make the combined holdings exceed the applicable percentage limitation, the foundation cannot thereafter acquire more stock to restore its holdings to the former level (unless the combined holdings after such acquisition by the foundation do not exceed 20 percent).

Grandfathered holdings

The 1969 Act provided special rules applicable where the business holdings of a private foundation (combined with disqualified persons) exceeded the 20-percent/35-percent limitation on May 26, 1969. These special rules also apply to holdings acquired under trusts irrevocable on that date, or certain wills executed by that date, even though the actual transfer to the foundation occurs later. In general, grandfathered holdings are permitted to be retained, but are subject to gradual reduction.

If, on May 26, 1969, the combined holdings of the foundation and disqualified persons exceeded 50 percent, the holdings are to be reduced over several phases. Under the first phase, by the deadlines shown below the combined foundation/disqualified person holdings

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[5] If all disqualified persons together do not own more than 20 percent of the voting stock of a corporation, there is no limit on the nonvoting stock which may be held by the private foundation.

To determine permitted holdings in a partnership, the foundation's "profits interest" is aggregated with the profits interests of all disqualified persons and substituted for the voting stock limitation applicable to corporations, and "capital interest" is used in place of nonvoting stock.

In computing the holdings of any business enterprise, stock or other interests owned, directly or indirectly, by a corporation, partnership, estate, or trust are considered as owned proportionately by the beneficial owners.

cannot exceed 50 percent of the voting stock of the corporation or, if less, 50 percent of the value of all outstanding shares—

Ownership on 5/26/69:	*Deadline to reach 50% combined holdings:*
More than 95% by foundation alone	May 26, 1989
More than 75% combined holdings	May 26, 1984
More than 50% combined holdings	May 26, 1979

After expiration of the first phase, a second set of divestiture requirements becomes operational. If disqualified persons do not own more than two percent of the corporate voting stock during the 15 years after the close of the first phase, the combined foundation/disqualified person holdings must be reduced to not more than 35 percent by the end of that period (i.e., for a foundation which itself owned 95 percent of the stock on May 26, 1969, by May 26, 2004); and after the end of the second phase, the foundation itself cannot hold more than 25 percent if disqualified person ownership exceeds two percent. If disqualified persons own more than two percent of the corporate voting stock during the 15 years after the close of the first phase, the voting stock held by the foundation must be reduced to 25 percent by the end of the 15-year period.

Where May 26, 1969 aggregate holdings did not exceed 50 percent, a further decrease generally will not be required if foundation holdings never exceed 25 percent.

Grandfathered holdings are subject to reduction by operation of the "downward ratchet" rule. The rule, in effect, provides that if there is any increase in the holdings of disqualified persons, the holdings of the foundation must be decreased accordingly and can never go up again to the former grandfathered or otherwise permitted level over 20 percent (or 35 percent, if applicable), even if the holdings of disqualified persons are thereafter reduced.

E. Prohibition on Jeopardizing Investments

Background

Under the law prior to the Tax Reform Act of 1969, a private foundation would lose its tax-exempt status if its accumulated income was invested in a manner which jeopardized the carrying out of its charitable purposes.

In 1969, the Congress found that the prior law rules were defective in two respects.[6] First, the prior law rule applied only to investments of accumulated income; it did not apply to investments of corpus. The Congress believed that investments of corpus which jeopardize carrying out of exempt purposes may reduce benefits to charity just as much as jeopardizing investments of accumulated income. In addition, the loss of exemption was too harsh a sanction, and a more objective and limited sanction was needed.

[6] See H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 31; S. Rep. No. 91-552, *supra* n.3, at 45-46; General Explanation of 1969 Act, *supra* n.3, at 46-47; 1965 Treasury Report, *supra* n.3, at 52-54.

Present law (Code sec. 4944)

The Tax Reform Act of 1969 in effect prohibited a private foundation from making investments of income or principal which would jeopardize carrying out its charitable purposes. Certain program-related investments, such as in low-income housing programs, are deemed not to violate this prohibition where the investment does not have a significant purpose of making profit.

Under this rule, foundation managers must exercise ordinary business care and prudence, as determined at the time of the investment, in providing for the long-term and short-term needs of the foundation in carrying out its exempt purposes. No category of investments is per se prohibited, and the standard of care and prudence is applied by taking into account the foundation's portfolio as a whole (Treas. Reg. sec. 53.4944-1(a)(2)).

F. Restrictions on Foundation Expenditures

Background

Since 1934, the Code has provided that no substantial part of the activities of an exempt charitable, educational, etc., organization may consist of carrying on propaganda or otherwise attempting to influence legislation. In addition, such organizations may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office. Finally, a charitable, etc., organization would lose its exempt status if its accumulated income was used to a substantial degree for purposes other than its exempt purposes.

In 1969, the Congress found that these prior-law rules were defective in several respects.[7] First, denial of exempt status was a harsh sanction for violation of these rules, especially since the standards on permissible levels of prohibited activities were imprecise. Second, because of the substantiality test, large foundations could engage in significant amounts of lobbying. Third, the law was unclear as to whether certain activities, such as voter registration campaigns and publication of the views, personalities, and activities of candidates, constituted prohibited activities. Finally, the Congress was concerned that some grants by foundations were not being used for charitable purposes, but instead were being used for such purposes as vacations or to subsidize the preparation of material furthering political viewpoints. The Congress also concluded that private foundations should take substantial responsibility for the proper use of grants they make.

Present law (Code sec. 4945)

In general

The Tax Reform Act of 1969 in effect prohibited private foundations from making expenditures for grassroots or direct lobbying, for political campaigns (subject to a narrow exception for certain nonpartisan voter registration drives), or for any noncharitable purpose. In addition, the 1969 Act in effect placed limitations on

[7] See H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 31-35; S. Rep. No. 91-552, *supra* n.3, at 46-51; General Explanation of 1969 Act, *supra* n.3, at 47-52.

foundation grants to individuals or to organizations other than public charities.

Grants to individuals

In the case of grants to individuals, the foundation must obtain advance approval from the Internal Revenue Service of its grant-making procedure (but not of specific awards). In addition, the grant must be made on an objective and nondiscriminatory basis, and must either (1) constitute a scholarship or fellowship excludable from the grantee's income under section 117(a), and be used for study at an educational institution; (2) constitute a nontaxable prize or award (as defined in sec. 74(b)); or (3) be made to "achieve a specific objective, produce a report or other similar product" or improve or enhance a capacity, skill, or talent of the grantee.

Grants to organizations

In general.—In the case of grants to organizations other than public charities, the private foundation must exercise "expenditure responsibility" over the grant. To ensure that such grants will be properly used by the recipient for charitable purposes, the grantor must make reasonable efforts, and establish adequate procedures, to see that the grant is spent solely for proper uses, to obtain full reports from the grantee, and to make full reports to the Internal Revenue Service on the grants. There is no exception in present law from the expenditure responsibility requirements for grants below a specified dollar amount.

Regulatory guidelines.—Treasury regulations expressly state that the expenditure responsibility rules do not make donor foundations insurers or guarantors of the activities of donee organizations, and set forth guidelines under which donor foundations may satisfy the section 4945 rules (Reg. sec. 53.4945-5(b)). For example, the regulations state that a private foundation considering a grant request should conduct a limited inquiry concerning the potential donee, complete enough to give a reasonable person assurance that the grant would be used for charitable purposes. The scope of the inquiry would vary with factors such as the dollar amount of the grant. No such pre-grant inquiry would be required if the donee organization had received prior grants from the donor foundation and had submitted to the donor the required reports substantiating proper use of the earlier grant funds.

The donor foundation must obtain a written commitment from the donee foundation that the latter will use the grant funds solely for charitable purposes and will submit reports as to whether the funds have been used in compliance with the grant terms. The grantor foundation need not conduct any independent verification of such reports unless it has reason to doubt their accuracy or reliability (Reg. sec. 53.4945–5(c)(1)). In meeting its own reporting requirements to the Internal Revenue Service, the grantor foundation may rely on statements from the donee organization or other records showing the information which the grantor, in turn, must report to the Service (Treas. Reg. sec. 53.4945-5(c)(4)).

Reliance on IRS classification.—As noted, the expenditure responsibility rules do not apply to grants to public charities, including publicly supported charitable organizations. Under Treasury regulations, once an organization has been classified as publicly supported, the determination of whether a grant is subject to the expenditure responsibility requirements generally will not be affected by the donee's subsequent loss of classification as a publicly supported organization until notice of loss of classification is published.

However, a donor foundation may not rely on the donee organization's classification if the donor foundation is responsible for or aware of a "substantial and material" change in the donee organization's sources of support that results in the organization's loss of classification as a publicly supported organization. In general, the donor foundation will not be considered responsible for or aware of such a change in support (and hence may rely on a published classification) if the grant is made in reliance on a detailed written statement by the grantee organization that the grant will not result in loss of public charity status, and the information in such statement would not give rise to a reasonable doubt as to the effect of the grant (Treas. Reg. sec. 1.509(a)-3(c)).

To facilitate reliance on published classificiations, the Internal Revenue Service has issued guidelines specifying circumstances under which a donor foundation will not be considered responsible for a "substantial and material" change in support of the donee organization. [8] In addition, the Internal Revenue Service has published guidelines specifying circumstances under which a grant will be considered "unusual" and hence will not cause the donee organization to lose its status as publicly supported.[9]

G. Prohibition on Self-Dealing

Background

Under a provision enacted in the Revenue Act of 1950, certain charitable organizations (generally corresponding to private foundations as defined by the 1969 Act) would lose their tax-exempt status for at least one year (and, in certain circumstances, eligibility to receive tax-deductible contributions) if the foundation engaged in certain "prohibited transactions" with related persons other than on an arm's-length basis.

The prior-law sanctions applied if a foundation—

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[8]Under these guidelines, a donor organization generally will not be considered responsible for a substantial and material change in support if the aggregate of gifts, grants, and contributions received from the donor organization for a taxable year does not exceed 25 percent of the aggregate support received by the donee organization from all other sources for the four taxable years immediately preceding the year of the grant (Rev. Proc. 81-6, 1981-1 C.B. 620). In such circumstances, the donor foundation can rely on the classification of the donee organization as publicly supported without risk that its grant will later be treated as causing the donee organization to lose its public charity status (thereby subjecting the donor foundation to excise tax penalties for failure to exercise expenditure responsibility).

[9]Under these guidelines, a grant generally will be considered unusual where six conditions are met: (1) the grant is not made by a donor foundation which created the donee organization or was a substantial contributor to the donee organization; (2) the grant is not made by a donor organization which is in a position of authority to the donee organization; (3) the grant is made in cash, readily marketable securities, or assets that directly further the exempt purpose of the donee organization; (4) the donee organization has received an advance or final ruling that it is classified as a publicly supported organization; (5) there are no material restrictions imposed on the grant; and (6) if the grant is intended to pay for the operating expenses of the donee organization, the grant is expressly limited to one year's operating expenses (Rev. Proc. 81-7, 1981-1 C.B. 621).

(1) lent any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

(2) paid any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

(3) made any part of its services available on a preferential basis to;

(4) made any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sold any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth to; or

(6) engaged in any other transaction which results in a substantial diversion of its income or corpus to—

the creator of the organization (if a trust); a person who had made a substantial contribution to such organization; a member of the family of an individual who was the creator of such trust or who had made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

In substituting the self-dealing prohibitions in the Tax Reform Act of 1969 for the arm's-length standards of prior law, the Congress found the previous rules to be defective in several respects.[10]

First, the Congress concluded that, as a practical matter, prior law had failed to preserve the integrity of private foundations. In some instances, the prior-law sanctions seemed so harsh in comparison to the offense involved that they caused reluctance in enforcement, especially in view of the element of subjectivity in applying arm's-length standards. Where the Internal Revenue Service sought to apply sanctions in such circumstances, the same factors encouraged extensive litigation and a noticeable reluctance by the courts to uphold severe sanctions.

Also, the Congress concluded that compliance with arm's-length standards often did not in itself prevent the use of a private foundation to benefit improperly those who control it. This is true, for example, where a foundation (1) purchases property from a substantial donor at a fair price, but does so in order to provide funds to the donor who needs cash and cannot find a ready buyer; (2) lends money to the donor with adequate security and at a reasonable rate of interest, but at a time when the money market is too tight for the donor to readily find alternate sources of funds; or (3) makes commitments to lease property from the donor at a fair rental when the donor needs such advance leases in order to secure financing for construction or acquisition of the property.

Accordingly, to minimize the need to apply subjective arm's-length standards, to avoid the temptation to misuse private founda-

[10] See H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 20-24; S. Rep. No. 91-552, *supra* n.3, at 28-34, General Explanation of 1969 Act, *supra* n.3, at 30-36; 1965 Treasury Report, *supra* n.3, at 15-23, 45-52, 88-92.

tions 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 1969 Act generally prohibited self-dealing transactions. This was based on the conclusion by the Congress that the highest fiduciary standards require complete elimination of all self-dealing, rather than merely imposition of arm's-length standards.

Present law (Code sec. 4941)

In general, the Tax Reform Act of 1969 in effect prohibited private foundations from engaging with disqualified persons in any of the following transactions—

(1) A sale, exchange, or lease of property;

(2) Lending of money or other extension of credit, except a loan by a disqualified person to a foundation without interest where the proceeds of the loan are used exclusively by the foundation in pursuit of its exempt purposes;

(3) Furnishing of goods, services, or facilities, except (a) where the goods, services, or facilities are furnished by the disqualified person without charge and used by the foundation in pursuit of its exempt purposes; or (b) where the furnishing by the private foundation to the disqualified person is on a basis no more favorable than that on which such items are made available to the general public;

(4) Payment of compensation (or reimbursement of expenses) by the foundation to a disqualified person, except for personal services which are reasonable and necessary for carrying out the exempt purposes of the foundation and the payment is not excessive;

(5) Transfer to, or use for the benefit of, a disqualified person of the income or assets of the foundation; and

(6) Payments to government officials, subject to certain exceptions (e.g., scholarships, prizes, and awards).

For purposes of the self-dealing rules, the term "disqualified person" generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such individuals, plus certain other related entities and government officials (sec. 4946). The disqualified family members are the person's spouse, ancestors, and all lineal descendants (and their spouses). The term "substantial contributor" means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the particular contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)).

H. Information Reporting and Public Disclosure Requirements

Background

Under the Revenue Act of 1943, certain tax-exempt organizations were required to file annual returns with the Internal Revenue Service listing their gross income, receipts, and disbursements. This annual return requirement did not apply to religious organizations, schools, certain fraternal organizations, publicly supported charities, and certain government corporations (i.e., generally those organizations that are not private foundations as defined by the 1969 Act).

In 1950, the annual return requirement was expanded to require listing gross income, expenses, disbursements for exempt purposes, accumulations, balance sheet, and the total amount of contributions and gifts received during the year. (These returns were in addition to any returns for unrelated business taxable income returns.) The information required to be furnished on the annual return was open to the public.

No specific sanctions were provided for failure to file an exempt organization return. However, certain criminal provisions could be applied in extreme cases.

In making several changes to these annual filing and disclosure requirements in the Tax Reform Act of 1969, the Congress concluded that the experience of the prior two decades had indicated that additional information was needed on a more current basis from all types of exempt organizations, and that this information should be made available more readily to the public, including State officials.[11] (Under State law, the Attorney General may have certain supervisory and enforcement powers over foundations and other charitable organizations.) Consequently, the 1969 Act applied expanded reporting requirements to all exempt organizations and, particularly, to private foundations.

Present law

Annual returns (Code sec. 6033(b))

With certain exceptions (e.g., for churches), every exempt organization must file an annual information return. The annual return requirement for a private foundation is satisfied by the filing of Form 990-PF, which includes the following information for the taxable year: gross income and related expenses, disbursements, a balance sheet showing assets, liabilities, and net worth, total contributions and gifts received, the names and addresses of all substantial contributors, the names and addresses of the foundation managers and highly compensated employees, and the compensation and other payments made to the foundation managers and highly compensated employees. A copy of the return filed with the Internal Revenue Service must be furnished by the foundation to the Attorney General (or other official) in the relevant State.

The failure to file a timely exempt organization information return (unless reasonable cause is shown) results in a sanction of $10 per day, up to a maximum of $5,000 as to any one return, imposed on the organization (sec. 6652(d)). Failure to file a return after a reasonable demand by the Internal Revenue Service (unless reasonable cause is shown) results in an additional sanction of $10 a day, up to a maximum of $5,000 as to any one return, imposed on the exempt organization officer or employee who fails to file the information return.

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[11] See H. R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 36-37; S. Rep. No. 91-552, *supra* n.3, at 52-53; General Explanation of 1969 Act, *supra* n.3, at 52-54; 1965 Treasury Report, *supra* n.3, at 64, 109-110.

Annual reports (Code sec. 6033(c))

The 1969 Act provided that every private foundation with at least $5,000 of assets at any time during the year was required to file an annual report in addition to the annual return. The principal additional information items required in the annual report (Form 990-AR) were the following: (1) itemized lists of assets showing book and market values; (2) itemized lists of grants, amounts, and purposes thereof, grantee names, addresses, and relationship to foundation managers or substantial contributors; and (3) lists of all foundation managers who are substantial contributors or who own at least 10 percent of any corporation, partnership, or other entity in which the foundation owns at least 10 percent.

For taxable years beginning after 1980, private foundations are no longer required to file a separate annual report. However, the information that was required to be filed on the annual report has been incorporated into the annual information return for private foundations (Form 990–PF). Also, the return currently requests certain information regarding applications for grants from the foundation (name, address, and telephone number of the person to whom applications should be addressed; any required format, information, and materials; deadlines for submitting applications and any limitations on the types of awards which the foundation makes, such as by geographical areas, charitable fields, kinds of donee institutions, etc).

Disclosure requirements (Code sec. 6104)

Under present law, all information required to be furnished on the private foundation annual return, including the names and addresses of any substantial contributor, must be made available to the public by the Internal Revenue Service. In addition, a copy of the private foundation annual return must be made available, at the principal office of the foundation, to any citizen who requests to inspect the return within 180 days after a notice of availability has been published. This notification must be published in a newspaper with general circulation, in the county in which the foundation's principal office is located, not later than the due date for filing the return.

Finally, the Internal Revenue Service is required to notify the Attorney General (or other official) of the relevant State in the event of (1) denial of tax-exempt status to an organization, (2) the operation of a charitable organization in a manner which fails to meet the requirements for tax-exempt status, or (3) the mailing of a notice of deficiency regarding taxes imposed on private foundations. In addition, the Service is to make available to such State officials information about the preceding items that are relevant to any determination under State law.

GAO study

On May 11, 1983, the General Accounting Office (GAO) presented its findings on a study of enforcement by the Internal Revenue Service of the reporting requirements for private foundations, in testimony before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations. The study was conducted by reviewing 1,682 returns filed primarily for tax years 1978-1981.

GAO concluded that private foundations generally comply with the reporting requirements which the Internal Revenue Service requires for tax administration. However, the study found that the Service devoted little attention to the reporting requirements which provide information that primarily is useful to the public and to the Congress for monitoring foundation activities. Accordingly, GAO stated, foundations often fail to submit this information.

Because GAO concluded that the reporting requirements provide valuable information both for public information purposes and for tax administration purposes, the study suggested that the Internal Revenue Service make certain changes in its enforcement activities to ensure availability of this information. These changes would require the Service to adopt a combined enforcement approach that involves revisions of (1) the service center correspondence program, (2) the district office system for selecting returns for examination, and (3) the examination process. In addition, the study suggested that the Service should assess the penalties for failure to file a (complete) return when a foundation does not provide all required information.

III. DEFINITIONS

A. Private Foundation v. Public Charity

Background

Since the Revenue Act of 1950, foundations have been subject to special restrictions on their expenditures, investments, and transactions, as well as to the general requirements and rules applicable to all tax-exempt charitable organizations (e.g., that the organization must be organized and operated exclusively for exempt purposes, as compared with private or business purposes). Similarly, as described in Part IV of this pamphlet, the distinction between foundations and public charities for purposes of the charitable deduction rules dates back to the 1954 Code.

Thus, the 1950 Act prohibitions on transactions with donors or other related persons (unless made on an arm's-length basis), and on unreasonable accumulations of income, applied generally to those charitable organizations defined by the Tax Reform Act of 1969 as private foundations. That is, the 1950 Act prohibitions applied to all tax-exempt charitable organizations other than churches (and certain religious organizations other than trusts), support organizations to churches, schools, hospitals, medical research or medical education organizations, and certain publicly supported organizations.

The 1950 Act provisions were enacted in light of findings by the tax committees, after study of the operations of exempt charitable organizations, which had revealed a number of cases where there had been misuse of foundations, including cases where donors had derived substantial benefits from dealing with foundations. However, the 1950 Act prohibitions were not applied to those organizations (churches, schools, publicly supported organizations, etc.) which "are in general what might be called 'public' organizations and because of this characteristic are not believed likely to become involved in"[12] misuse situations.

Likewise, in defining those charitable organizations subject to the private foundation rules enacted in the 1969 Act, the Congress concluded that in general the problems which necessitated enactment of the new rules would be especially prevalent in the case of private foundations, as compared with organizations as to which there was substantial public involvement in the form of broad public support (whether from contributions, membership fees, or receipts from related activities).[13]

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[12] S. Rep. No. 2375, 81st Cong., 2nd Sess. 38 (1950); H.R. Rep. No. 2319, 81st Cong., 2d Sess. 42 (1950).

[13] See, H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 40-41; S. Rep. No. 91-552, *supra* n.3, at 56-59; General Explanation of 1969 Act, *supra* n.3, at 57-60.

In general

The term "private foundation" was defined in the Tax Reform Act of 1969 by a process of exclusion. That is, any charitable, educational, religious, etc. organization (including a charitable trust) which is described in Code section 501(c)(3) and tax-exempt under section 501(a) constitutes a private foundation, unless the organization establishes that it is excluded from foundation status under one of the three categories of organizations (described below) collectively referred to as public charities.[14]

Section 509(a)(1) organizations

This category of public charities consists of certain organizations defined by reference to their nature—churches, educational institutions (schools, colleges, and universities), certain organizations established to fund State colleges or universities, hospitals, medical research organizations operated in conjunction with hospitals, and governmental units—plus certain organizations defined by reference to their public support. For this purpose, an organization qualifies as publicly supported if it satisfies either a mechanical test or a facts and circumstances test.

Mechanical (one-third) test

To meet the mechanical public support test, the organization must normally receive at least *one-third* of its total support (all receipts except those from related business activities and except for "unusual grants") as qualified grants or contributions. The latter term means the total amount of grants or contributions from section 170(b)(1)(A)(vi) publicly supported charities or from governmental units, plus any contribution received from an individual, trust, or corporation but only to the extent not exceeding two percent of the organization's total support.

Facts and circumstances (10 percent) test

Alternatively, as long as the organization receives at least *ten percent* of its support in the form of such qualified grants or contributions, the organization will be treated as a public charity if it is operated so as to attract new and additional public support on a continuous basis, and if all the pertinent facts and circumstances establish that it is in the nature of a publicly supported organization. The relevant factors include the amount and nature of its support from public or governmental sources, whether it has a governing board representing the broad interests of the public, whether it makes its facilities or services available to the public, whether its membership represents a broad cross section of the interested public, whether it is accountable to a government agency or public charity from which it receives a significant part of its funds, etc.

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[14] Also, sec. 501(c)(3) organizations which are organized and operated exclusively for testing for public safety are excluded from private foundation status.

Community foundations

Community foundations are trusts which are established to attract large contributions of a capital or endowment nature to benefit a particular community or area. Contributions to a community foundation are often received and maintained in the form of separate trusts or funds. The Treasury regulations contain detailed rules indicating when these trusts or funds are to be treated as a single entity (Reg. sec. 1.170A-9(e)(11)). In order for this single entity to be treated as a publicly supported organization, it must satisfy either the mechanical (one-third) test or the facts and circumstances test.

In general, in order to be treated as a component part of a community foundation, a trust or fund must be given to a community foundation and must not be subject to any restriction or condition with respect to the transferred assets. Trusts or funds generally will be treated as part of a single community foundation if: (1) the trusts or funds are commonly known as a community trust, fund, foundation, or similar name; (2) the trusts or funds are subject to a common governing instrument or master agreement; (3) the trusts or funds have a common governing body or distribution committee; (4) the governing instrument permits modification of any restriction on the distribution of funds, and replacement of any trustee for breach of fiduciary duty or for failure to produce a reasonable rate of return; (5) the governing body commits itself to exercise its powers in the best interests of the community and to insure than each trust or fund produces a reasonable rate of return; and (6) the trusts or funds must prepare common periodic reports.

In addition, the Treasury regulations contain more liberal transitional rules for certain community foundations which were in existence before 1976, which allow such community foundations to be treated as publicly supported under the special rules until 1982, and to qualify under the general rules thereafter.

Section 509(a)(2) organizations

Under this mechanical test for public charity status, an organization must normally receive more than one-third of its total support (including contributions, grants, membership fees, gross receipts from related business activities, and gross investment income) from qualified donors in any combination of contributions, grants, membership fees, and certain limited amounts of gross receipts from related activities. The term qualified donors means section 509(a)(1) public charities, governmental units, and persons who are not substantial contributors (and who do not otherwise constitute disqualified persons). In addition, the organization must normally receive not more than one-third of its total support from gross investment income (interest, dividends, etc.).

Section 509(a)(3) organizations

An organization constitutes a public charity under this category if (i) it is organized and operated exclusively for the benefit of, or to carry out the purposes of, one or more designated section 509(a)(1) or section 509(a)(2) public charities; (ii) it is operated, supervised, or controlled by or in connection with one or more such designated public charities; and (iii) it is not controlled by disqualified persons (other than the foundation managers or the designated public charities). These public charities are sometimes referred to as supporting organizations or satellite organizations.

Nonexempt trusts having charitable beneficiaries (Code sec. 4947)

"Split-interest" trusts

If a nonexempt trust has both charitable and noncharitable interests (e.g., in the case of a charitable remainder trust, prior to the death of the income beneficiary), the foundation rules relating to self-dealing and taxable expenditures generally apply with respect to trust amounts for which a charitable deduction was allowed, except for amounts transferred in trust before May 27, 1969 (sec. 4947(a)(2)). However, so long as its status as a "split-interest" trust continues, the trust generally is not subject to the other foundation rules or the two-percent tax on net investment income.

Charitable trusts

If all the unexpired interests in a nonexempt trust are devoted to charitable purposes (e.g., in the case of a charitable remainder trust, after the death of the income beneficiary), and if the trust does not qualify as a public charity, the trust generally is subject to all the private foundation rules and excise taxes (with no exception for amounts transferred in trust before 1969) (sec. 4947(a)(1)). This provision precludes avoidance of the foundation rules merely by organizing as a nonexempt trust rather than as an exempt trust or corporation.

B. Operating v. Nonoperating Foundation

Private foundations are classified by the tax law as either operating—basically, foundations which themselves directly engage in charitable, educational, or religious functions—or nonoperating—basically, grantmaking foundations. The advantages of operating foundation status are:

(1) Contributions to operating foundations are deductible by individual donors to the same extent as contributions to public charities, while contributions to nonoperating foundations (with certain exceptions) receive less favorable treatment.

(2) Foundation grants to operating foundations generally may be counted by the donor foundation as qualifying distributions in satisfaction of the section 4942 payout rules, while grants to nonoperating foundations do not so qualify (with certain exceptions).

(3) Operating foundations are not subject to the section 4942 payout rules (although they must meet certain expenditure requirements to be classified as operating), while all nonoperating foundations are required to satisfy the section 4942 payout rules.

In general, a private operating foundation is defined (sec. 4942(j)(3)) as a foundation which expends directly for the active conduct of exempt activities at least 85 percent of the lesser of (a) its adjusted net income or (b) its minimum investment return (i.e., five percent of the value of its investment assets). Also, the foundation must meet one of three tests relating to its use of assets, operating expenditures, or support.

Under the first test, 65 percent or more of the assets of the foundation must be devoted directly to the active conduct of its charitable activities or to functionally related businesses. Under the second test, the organization must normally spend an amount not less than two-thirds of its minimum investment return directly for the active conduct of its charitable activities. Under the third alternative test, the organization must receive at least 85 percent of its support from five or more exempt organizations and from the general public, and not more than 25 percent of the foundation's support may be received from any one exempt organization.

C. Disqualified Persons

The term "disqualified person" generally includes substantial contributors, foundation officers, directors, or trustees, and members of the family of such an individual, plus certain other related entities (Code sec. 4946). The disqualified family members are the person's spouse, ancestors, and all lineal descendants (and their spouses). The term "substantial contributor" means a person whose contributions to the foundation exceeded two percent of all contributions received by the foundation before the close of the year in which the contribution is made, but only if the person's contributions exceed $5,000 (sec. 507(d)(2)).

IV. CHARITABLE DEDUCTION RULES

Background

Since the 1954 Code, the income tax treatment of contributions to private foundations generally has been less favorable than the treatment of contributions to public charities. Thus, deductions up to an additional 10 percent of adjusted gross income were allowed for contributions to churches, schools, and hospitals (1954 Code), medical research organizations operating in conjunction with hospitals (P.L. 1022, 1956), organizations supporting State universities (P.L. 87-858, 1962), and publicly supported organizations (Revenue Act of 1964).

In providing (under prior law) an additional 10 percent limitation on deducting contributions to public charities while retaining the 20 percent limitation on deducting contributions to foundations, the tax-writing committees drew this distinction on the ground that there may be delays (in some instances, for extended periods) in redistributions by foundations of contributed funds to operating charitable organizations or programs. The additional incentive for contributions to public charities was intended "to encourage immediately spendable receipts of contributions" for charity,[15] so that the donated funds for which the special tax incentive was allowed would more promptly reach the ultimate beneficiaries.

Consistently with this underlying objective, the 1969 Act extended favorable tax treatment (e.g., the present-law 50 percent limitation) to private operating foundations—i.e., foundations which expend their funds directly in charitable programs, rather than making grants to other organizations for the latter to then apply to charitable uses. In addition, the only two types of private nonoperating foundations made eligible for the more favorable treatment were organizations which redistribute, within specified periods, all contributions received to public charities or operating foundations.

Present law (Code sec. 170)

In general

The 1969 Tax Reform Act modified prior-law rules governing charitable deductions for contributions by individuals to public charities and private foundations.[16] In general, the 1969 Act retained the differing treatment (dating from the 1954 Code and the Revenue Act of 1964) of contributions to public charities and contributions to private nonoperating foundations, but extended the

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[15] H.R. Rpt. No. 749, 88th Cong., 1st Sess. 53 (1963); S. Rpt. No. 830, 88th Cong., 2d Sess. 58 (1964).

[16] See H.R. Rep. No. 91-413 (Pt. 1), *supra* n.3, at 51-56; S. Rep. No. 91-552, *supra* n.3, at 77-82; General Explanation of 1969 Act, *supra* n.3, at 75-79; 1965 Treasury Report, *supra* n.3, at 58-63.

more favorable treatment for public charities to private operating foundations.

Percentage limitations

The maximum amount which an individual may deduct in one year was raised from 30 to 50 percent of the donor's adjusted gross income for contributions (other than of capital-gain property) to public charities, and from 20 to 50 percent for contributions to private operating foundations. The 50-percent limitation applies to private nonoperating foundations only if they either redistribute all contributions within a specified period after receipt or qualify as a "pooled fund" foundation. For contributions of capital-gain property to organizations otherwise qualifying for the 50-percent limitation, the limitation generally is 30 percent. In the case of all private nonoperating foundations other than the two categories eligible for the 50-percent/30-percent limitations, the 1969 Act retained the lower percentage (20 percent) which had been generally applicable to private foundations since the 1954 Code.

Amounts in excess of the 50-percent/30-percent limitations may be carried forward and deducted over the following five years (subject to applicable percentage limitations in those years). There is no carryover of excess deduction amounts where the 20-percent limitation applies.

Contributions of appreciated property

In the case of donations by individuals of capital-gain property to private nonoperating foundations where the 20-percent limitation applies, the 1969 Act provided that the amount deductible equals the asset's fair market value reduced by 50 percent (changed to a 40 percent reduction by the Revenue Act of 1978) of the unrealized appreciation, i.e., of the amount by which the value exceeds the donor's basis in the property. In the case of donations by individuals of capital-gain property to public charities, etc., where the 30 percent limitation applies, there is no reduction from fair market value.

Also, the 1969 Act required certain reductions in the deductible amount for contributions of donated ordinary-income property, or of tangible personal property (such as art works) if use by the donee of the property is unrelated to its exempt purposes, whether such property is contributed to a public charity or a private foundation. Some of the changes made by the 1969 Act to the deduction rules for donations of appreciated property were intended in part to preclude situations under prior law where a taxpayer could realize a greater after-tax profit by making a gift of the property than by selling it, paying tax on the gain, and keeping the proceeds.

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