The Failures and the Future of Private Foundation Governance

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When the private foundation governance restrictions of the 1969 Tax Reform Act were enacted, dire predictions abounded. One commentator referred to the Act as tantamount to Congress's having "thrown out the charitable baby with the dirty bathwater," "encouraging the abandonment" of private foundations, "interfering with their effective operation, attacking their involvement in major social problems and prohibiting what are in essence equitable transactions."[1] Another forecasted that "[a]ll of the odds seem stacked against" the growth of new foundations, "given the range of disincentives built into the law."[2] A third feared that the restrictions would increase the "death rate among small private foundations[,]" generating "a detrimental effect on the pluralism of our social order."[3]

Measured solely by IRS data on the number and holdings of existing private foundations, these predictions appear not to have been borne out. According to the IRS, in 2016, over 100,000 private foundations were on record as filing annual reports, with nearly $890 billion in collective assets,[4] suggesting that private foundations are thriving. A

 I would like to thank Alan S. Halperin, Jonathan Yehuda, and Elliot Orol for their invaluable guidance and review of multiple outlines and drafts; my interviewees, who generously shared their insights; the Personal Representation Department at Paul, Weiss for its support of my research and writing; the staff of the library at Paul, Weiss, Alexis Kaufman, and Brian Erickson for their excellent research assistance; and Professors Daniel Hulsebosch and Frank Upham at New York University School of Law for their wise counsel and editorial recommendations.

1 Nathaniel L. Goldstein & Donald L. Sharpe, *Private Charitable Foundations After Tax Reform*, 56 A.B.A. J., May 1970, at 447, 452.

2 Homer C. Wadsworth, *Private Foundations and the Tax Reform Act of 1969*, 39 L. & Contemp. Probs. 255, 262 (1975).

3 William H. Smith & Carolyn P. Chiechi, Private Foundations: Before and After the Tax Reform Act of 1969 82 (1974).

4 Internal Revenue Serv., Table 1. Domestic Private Foundations: Number and Selected Financial Data, by Type of Foundation and Size of Fair Market Value of Total Assets, Tax Year 2016, https://www.irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics#2 [https://perma.cc/493S-CADX]. By contrast, the Treasury Department's landmark 1965 study of private foundations noted the existence of only 14,865 organizations that would qualify as private

closer look at the 1969 Tax Reform Act's foundation governance-related provisions and their legacy, however, reveals a more complicated story. This article argues that the large number of existing private foundations and the significant value of their holdings mask a deep-seated and growing frustration with the restrictions imposed by the Act that threatens to dethrone the private foundation from its historical primacy in the field of private philanthropy. Ironically, then, the grim forecasts from the Act's early days may well, 50 years later, be coming true.

Judging by the remarkable achievements of private foundations since the first such organizations were founded in the Gilded Age, this primacy is merited. The Rockefeller Foundation made highly effective grants in 1915 to fight the yellow fever epidemic;[5] the Carnegie Corporation provided critical early support to public libraries throughout the country in the late 19th and early 20th centuries;[6] the Sarah Scaife Foundation made a substantial grant to support the laboratory that ultimately developed a cure for polio;[7] and the Robert Wood Johnson Foundation supported the development of the 911-dial emergency response system.[8] More recently, foundations have joined the efforts to fight the COVID-19 pandemic;[9] the Libra Foundation, funded by a branch of the Pritzker family, distributed $350,000 in rapid-response grants over the course of only three weeks to organizations helping families separated at the border between the United States and Mexico;[10] and 15 Michigan-based

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foundations under the definition that was adopted in the 1969 Tax Reform Act, with total assets of $16.26 billion, or just under $135 billion in 2020 dollars (adjusted for inflation). S. COMM. ON FIN., 89TH CONG., REP. ON PRIVATE FOUNDATION 74 tbl.7, 79 tbl.10, 83 tbl.11 (Comm. Print 1965) [hereinafter TREASURY REPORT]; U.S. INFLATION CALCULATOR, https://www.usinflationcalculator.com/ [https://perma.cc/39XV-SNVS].

5 Peter Frumkin, *The Long Recoil from Regulation: Private Philanthropic Foundations and the Tax Reform Act of 1969*, 28 AM. REV. PUB. ADMIN. 266, 266 (1998); Erling Norrby, *Yellow Fever and Max Theiler: The Only Nobel Prize for a Virus Vaccine*, J. EXPERIMENTAL MED., Nov. 26, 2007, at 2779, 2799, https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2118520/pdf/jem2042779.pdf.

6 Frumkin, *supra* note 5, at 266; Debra Viadero, *Carnegie Corp. Repeats History with New Library Grants,* EDUC. WEEK (June 16, 1999), https://www.edweek.org/policy-politics/carnegie-corp-repeats-history-with-new-library-grants/1999/06 [https://perma.cc/R2UU-2VAF].

7 Frumkin, *supra* note 5, at 266-67; Caitrin Keiper, *Conquering Polio*, THE PHILANTHROPY ROUNDTABLE (Summer 2012), https://www.philanthropyroundtable.org/philanthropy-magazine/article/conquering-polio [https://perma.cc/X72G-PXVY].

8 Paul Sullivan, *Notre-Dame Donation Backlash Raises Debate: What's Worthy of Philanthropy?*, N.Y. TIMES (Apr. 26, 2019), https://www.nytimes.com/2019/04/26/your-money/notre-dame-donation-backlash-philanthropy.html [https://perma.cc/XH8T-Z93T].

9 *See, e.g.*, Mark Suzman, *Announcing the COVID-19 Therapeutics Accelerator*, BILL & MELINDA GATES FOUND. (Mar. 9, 2020), https://www.gatesfoundation.org/The-Optimist/Articles/coronavirus-mark-suzman-therapeutics [https://perma.cc/5NDF-V4F4].

10 *See* Philip Rojc, *Inside the Libra Foundation: How a Branch of the Pritzker Family Backs Movement Building*, INSIDE PHILANTHROPY (Oct. 22, 2018), https://

and national foundations joined forces to rescue the lauded art collection of the Detroit Institute of Arts.[11] And it is no accident that these achievements have all been fostered by private foundations. As the Treasury Department noted in its landmark 1965 study of private foundations, these organizations are particularly nimble: they "can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly . . . . [B]ecause their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another."[12] The Treasury Department concluded that private foundations "constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity."[13] Private foundations, as these successful programs and the Treasury Department's assessment demonstrate, are particularly well-suited to meeting specific societal needs that would otherwise go unaddressed.

The Act, however, has jeopardized the possibility of private foundations' continuing this pattern of landmark achievements. The unnecessary complexity of the Act has proven to be a minefield for even the most seasoned nonprofit experts. The bright-line nature of particular rules and foundations' inability to engage in dialogue with regulators — owing partly to chronic underfunding of the IRS's enforcement arm — have caught too many innocent acts in the excise tax net. And the form-over-substance aspect of certain requirements, coupled with the rise of alternative philanthropic vehicles that are able to avoid these requirements, has engendered a lack of public confidence in the regulatory regime.

The cumulative effect of these issues has been to precipitate the decline of private foundations in favor of substantially — and, arguably, troublingly — less restrictive alternatives, which are largely structured in ways that make it less likely that they will achieve the type of broad-ranging social benefit that private foundations have historically fostered. Donor-advised funds, or DAFs, for example, which are among the most popular recipients of charitable contributions, are structured such that it is virtually impossible for a visionary donor to use the vehicle to establish and administer ongoing socially-beneficial programs. Furthermore,

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www.insidephilanthropy.com/home/2018/10/22/inside-the-libra-foundation-how-a-branch-of-the-pritzker-family-backs-movement-building [https://perma.cc/WGL5-LVS5].

11 Liz Essley Whyte, *Philanthropy Keeps the Lights on in Detroit*, The Philanthropy Roundtable (Winter 2014), https://www.philanthropyroundtable.org/philanthropy-magazine/article/philanthropy-keeps-the-lights-on-in-detroit [https://perma.cc/YD2T-LFSS].

12 Treasury Report, *supra* note 4, at 5.

13 *Id.*

DAFs are not required to make any annual distributions for charitable purposes, and nearly 22% make no annual distributions at all,[14] which means that donors receive an immediate income tax deduction for donations without any assurance to the public of corresponding social benefit. Section 501(c)(4) social welfare organizations, another type of alternative philanthropic vehicle that has become quite popular in recent years, are appealing to donors in significant part because they act as a shelter from capital gains tax, because the use of their assets need not be restricted to traditional charitable purposes, and because, relatedly, their activities may inure in part to their donors' benefit. These attributes, collectively, make it highly unlikely that 501(c)(4) organizations would foster the benefits of foundations past because donors often use them for reasons that have little to do with a passion for particular philanthropic endeavors. Given these alternatives — which lack the structural features that make foundations uniquely suited to address changing and urgent philanthropic needs — and the manifest social good that foundations have achieved, the decline of private foundations is undesirable and should be averted.

This article proceeds in four parts. Part I reviews the history of foundation governance prior to the 1969 Tax Reform Act, including the concerns that motivated Congress to enact the Act's restrictions. Part II provides an overview of the rules that were enacted. Part III evaluates the legacy of these rules over the past 50 years, arguing that, while well-intentioned, the rules have not achieved their aims and, in fact, have served to drive interest away from establishing private foundations. Part IV proposes solutions to revitalize interest in creating and funding private foundations, including directing more resources to the IRS's audit function by earmarking the "audit fee" proceeds as intended; jettisoning bright-line rules in the self-dealing and, to a lesser extent, excess business holdings contexts in favor of fact-specific determinations; incentivizing good grant-making through open dialogue between regulators and foundations; and removing unnecessary barriers to making grants to foreign charities.

Research is based not only on traditional sources, such as legislative history and scholarly articles, but also on interviews with leading practitioners in the field of nonprofit law, administration, and governance;

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14 Lewis B. Cullman & Ray Madoff, *The Undermining of American Charity*, N.Y. Rev. Books (July 14, 2016), https://www.nybooks.com/articles/2016/07/14/the-undermining-of-american-charity/ [https://perma.cc/NE7C-HS2W]; Ray Madoff, *Three Simple Steps to Protect Charities and American Taxpayers from the Rise of Donor-Advised Funds*, Nonprofit Q. (July 25, 2018), https://nonprofitquarterly.org/three-simple-steps-to-protect-charities-and-american-taxpayers-from-the-rise-of-donor-advised-funds/ [https://perma.cc/6C9W-LKA3].

academics who specialize in these fields; and current and former government officials affiliated with the IRS and the Treasury Department. These interviewees' anecdotes and insights are vital to painting a complete picture of the landscape of private foundations today — one starkly at odds with what the IRS's raw data would otherwise suggest.

I. Historical Context: Private Philanthropy in the United States

The history of private philanthropy in the United States is one of conflicting impulses. On the one hand, since the country's founding, Americans have shown dedication to supporting charitable causes, and the government, at both the federal and state levels, has sought to encourage a culture of individual giving by rewarding charitable donors with tax incentives. On the other hand, the current deep-seated unease with the prominence in American social and political life of private philanthropic organizations[15] stretches back to the country's inception as well. These parallel undercurrents have, over time, traded places of prominence in a way that has shaped the regulation of private foundations, and played a significant role in the drafting and enactment of the Tax Reform Act of 1969.

A. Early Days

America's culture of private philanthropy is as old as the country itself. When Alexis de Tocqueville visited the country in 1831, he expressed awe at the widespread commitment to charitable causes that he observed among the population.[16] Perhaps the single best-known private philanthropist of early America was Benjamin Franklin, who aimed to create socially-beneficial programs through private organizations. He created a group called the Junto, which brought together private citizens to engage in various civic endeavors; established an organization of volunteer firefighters in Philadelphia; personally formulated plans to improve the physical state of Philadelphia's streets and to police neighborhoods; and was among the founders of the University of Pennsylvania.[17] While perhaps atypical in the extent of his philanthropic endeavors, Franklin was hardly unique among early Americans in his dedication to charitable causes.[18]

To immunize private philanthropy from government interference, however, the Supreme Court's involvement was required. In the 1819

15 *See infra* text accompanying notes 201-03.
16 Smith & Chiechi, *supra* note 3, at 5.
17 *Id.*
18 *Id.*

Dartmouth College case, the Supreme Court applied the Contracts Clause of the U.S. Constitution to invalidate the New Hampshire legislature's attempt to establish state control over Dartmouth's governance and operations.[19] The case is notable for being one of the earliest American examples of a court sanctioning a private corporation established for charitable purposes.[20] Twenty-five years later, in the 1844 case of *Vidal v. Girard's Executors*, the Supreme Court removed an American holdover from English common law and confirmed that a private citizen's charitable contributions — in that case, a testamentary bequest to establish a school for orphans[21] — would be enforced, even if made to associations that were not incorporated under state law.[22] As a result of *Girard*, federal law was largely settled by the mid-19th century: private philanthropic dispositions would be respected and insulated from government interference.

And yet, as evidence of the early tension between support and suspicion of private philanthropy, while the Supreme Court was in the process of clearing the way, some states installed roadblocks to private philanthropic dispositions. In the years after independence, seven states — Maryland, Michigan, Minnesota, New York, Virginia, West Virginia and Wisconsin — invalidated charitable trusts out of inherited distrust of both the Anglican Church and perpetual restraints on alienation of property.[23] In 1829, between *Dartmouth College* and *Girard*, New York's legislature enacted a statute based on England's Mortmain law that "severely restrict[ed] devises to charity and codified a trust law regime without the inclusion of a charitable trust, thus severely restricting the likelihood a charitable gift would be upheld."[24] While these restrictions gradually fell away over the ensuing decades, some state legislatures remained hesitant: New York's statute, for instance, was not expressly overturned until the Tilden Act of 1893.[25]

B. The Gilded Age, its Backlash, and Congress's Response

The first organizations that resembled modern private foundations were established in the Gilded Age. Wealthy industrialists, following in

19 Trs. Dartmouth Coll. v. Woodward, 17 U.S. 518, 518 (1819).

20 *Id.* at 646-50.

21 Vidal v. Girard's Executors, 43 U.S. 127, 129 (1844). This testamentary bequest was especially controversial because Girard's will specified that clergymen would be prohibited from teaching at the school. *Id.* at 133.

22 *Id.* at 198-201.

23 William H. Byrnes, IV, *The Private Foundation's Topsy Turvy Road in the American Political Process*, 4 HOUS. BUS. & TAX L.J. 496, 503-04 (2004).

24 *Id.* at 504.

25 *See* James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 628-29 (1985).

the American tradition of private philanthropy, sought to create mechanisms to formalize their charitable giving. Andrew Carnegie's 1889 article "Wealth" functioned as a quasi-manifesto for these industrialists, arguing:

> This, then is held to be the duty of the man of Wealth: First, to set an example of modest, unostentatious living, shunning display or extravagance; to provide moderately for the legitimate wants of those dependent upon him; and after doing so to consider all surplus revenues which come to him simply as trust funds, which he is called upon to administer, and strictly bound as a matter of duty to administer in the manner which, in his judgment, is best calculated to produce the most beneficial results for the community — the man of wealth thus becoming the mere agent and trustee for his poorer brethren, bringing to their service his superior wisdom, experience, and ability to administer, doing for them better than they would or could do for themselves.[26]

Carnegie's philosophy, shared by other magnates — among them John D. Rockefeller and Margaret Olivia Slocum Sage — precipitated the founding of the first private foundation-type organizations, many of which still exist today and have formulated lauded social programs.[27] By 1910, wealthy industrialists had created more than 60 such entities.[28] Notably, their rationales for doing so had nothing to do with individual tax benefits: there was no charitable income tax deduction available at the time.[29] These early foundations set the precedent for establishing organizations aimed at fostering significant and targeted social benefit. The Rockefeller Foundation, for instance, began making grants in 1915 to fight the yellow fever epidemic, and the Carnegie Corporation made grants to support public libraries across the country.[30]

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26 Andrew Carnegie, *Wealth*, 148 N. Am. Rev. 653, 661-62 *(1889)*, *reprinted in* The Gospel of Wealth 12 (2017), https://media.carnegie.org/filer_public/0a/e1/0ae166c5-fca3-4adf-82a7-74c0534cd8de/gospel_of_wealth_2017.pdf.

27 *See infra* text accompanying notes 70-72.

28 Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 Emory L.J. 1093, 1103-04 (2001).

29 See Smith & Chiechi, *supra* note 3, at 11-12 (illustrating that there was no charitable income tax deduction in 1910). In fact, there was no income tax at all until the Sixteenth Amendment took effect in 1913. U.S. Const. amend. XVI. The income tax charitable deduction was enacted four years later. War Revenue Act of 1917, Pub. L. No. 65-50, § 1201(2), 40 Stat. 300, 330. The assets of the foundations were, however, exempt from tax. *Id.*; *see also* 1 Comm'n on Indus. Rels., Final Report of the Commission on Industrial Relations, at 81, *reprinted from* S. Doc. No. 64-415 (1916) [hereinafter Walsh Commission Report Vol. 1].

30 Frumkin, *supra* note 5, at 266.

The backlash was not far behind. The 1916 report of the Walsh Commission, known formally as the Commission on Industrial Relations, which Congress established in 1912, represented the first instance of members of Congress conveying skepticism about private foundations in an organized fashion. The report expressed concern about economic benefits inuring to the donors who created these organizations, these organizations' assets not being subject to tax, and a small subset of wealthy individuals exerting undue control over American life.[31] Despite the Commission's having heard some pro-foundation testimony — including, unsurprisingly, from John D. Rockefeller, who testified that funds dedicated for private philanthropic purposes "should be left as large as possible to continue to make the substantial contributions to the wealth of the community in which they operated"[32] — the report concluded that wealthy industrialists were coming to control "the education and 'social service' of the Nation . . . largely through the creation of enormous privately managed funds for indefinite purposes, hereinafter designated 'foundations,'" that "are exempt from taxation, yet during the lives of the founders are subject to their dictation for any purpose other than commercial profit."[33] The Commission found that these foundations' assets "represent largely the results either of the exploitation of American workers through the payment of low wages or of the exploitation of the American public through the exaction of high prices."[34]

The Walsh Commission's recommendations were aimed primarily at ensuring a layer of government oversight of private foundations — a harbinger of Congressional action later in the century. Among other suggestions, the Commission recommended that each foundation with assets exceeding $1 million and having more than one function be required to obtain a federal charter, which should specify the foundation's powers and activities; mandate that funds not be accumulated in the foundation; permit "[r]igid inspection of the finances" of the foundation; and require that the foundation make reports about its operations to the

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31 Walsh Commission Report Vol. 1, *supra* note 29, at 80-83.

32 8 COMM'N ON INDUS. RELS., 64TH CONG., INDUSTRIAL RELATIONS: FINAL REPORT AND TESTIMONY, at 7858 (1916).

33 Walsh Commission Report Vol. 1, *supra* note 29, at 81.

34 *Id.* at 82. Interestingly, some private foundation opponents objected on more philosophical grounds. Henry Ford, for instance, argued that philanthropy and charity prevented people from "help[ing] themselves." 8 COMM'N ON INDUS. RELS. at 7630. This opposition is ironic given the Ford Foundation's significant endowment in the immediate pre-Act period and the degree to which its grant-making constituted a catalyst for the 1969 Tax Reform Act. *See* TREASURY REPORT, *supra* note 4, at 80 (discussing the assets of the Ford Foundation relative to all foundations); *see also infra* text accompanying notes 87-91 (illustrating examples of grants made by the Ford Foundation).

government that would be publicly available.[35] The Commission recommended that Congress study foundations further,[36] a recommendation that Congress would belatedly take up several decades later.[37]

Despite the forceful opposition to foundations evidenced in the Commission's report, Congress's immediate response reflected a diametrically opposed view of foundations.[38] In 1917, Congress passed laws granting individuals an income tax deduction for their charitable contributions, which was limited to 15% of the donor's adjusted gross income,[39] and Congress continued to adopt what one scholar calls a "laissez-faire attitude" toward private foundations in the following decades.[40] It was not until the 1940s, when the number of private foundations began to increase substantially and their assets grew noticeably, that Congress and the public showed renewed interest. Public reports of families gifting nonvoting stock in corporations to foundations and retaining control of these businesses while receiving tax deductions, for instance, engendered widespread criticism.[41] And even when Congress finally legislated in 1950, the results were hardly what the Walsh Commission's members would have desired.[42]

C. The 1950 Legislation

Congress legislated in 1950 to address some of the concerns that the Walsh Commission had raised and that others had taken up in subsequent decades. The resulting legislation, however, had practical effects that were less significant than foundation critics hoped, and Congress ultimately followed the legislation with the establishment of a number of committees to further study private foundations and make new regulatory recommendations.

As Congress considered the provisions that would ultimately comprise the 1950 legislation, Treasury Secretary John Wesley Snyder explained the Truman Administration's concerns about private

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35 Walsh Commission Report Vol. 1, *supra* note 29, at 85.

36 *Id.*

37 *See infra* text accompanying note 69.

38 *See* Walsh Commission Report Vol. 1, *supra* note 29, at 82-85; *see also* War Revenue Act of 1917, Pub. L. No. 65-50, § 1201(2), 40 Stat. 300, 330. The legislative history of the War Revenue Act does not contain an explanation for this disparity.

39 War Revenue Act § 1201(2).

40 Smith & Chiechi, *supra* note 3, at 16.

41 Charles T. Clotfelter, Federal Tax Policy and Charitable Giving 260-61 (1985).

42 It is notable, however, that despite the negative attention private foundations attracted, this was a period of fertile, socially-beneficial activity for private foundations. In 1948, for instance, the Sarah Scaife Foundation made a grant that supported the laboratory that ultimately developed a cure for polio. *See* Frumkin, *supra* note 5, at 266-67.

foundations to the Ways and Means Committee. Echoing the concerns of the Walsh Commission, he argued:

> Another . . . abuse of tax exemption involves the establishment of so-called charitable foundations or trusts which serve as a cloak for controlling businesses. The present law permits the transfer of business investments to tax-exempt trusts and foundations for these purposes without payment of estate or gift taxes. The income subsequently received from the business . . . is exempt from income tax. The abuse to which this type of device lends itself is the retention and reinvestment of a major share of the trust income in a manner which will benefit the grantor.[43]

Snyder then proposed a minimum payout requirement for private foundations, as well as "a prohibition against dealings between the trust [or foundation] and its creator or businesses under his control and against the use of the trust [or foundation] for the personal advantage of the grantor."[44] Interestingly, while not taken up in the 1950 legislation, these proposals would find echoes in the 1969 Tax Reform Act.

The Ways and Means Committee of the House of Representatives, too, proposed legislation at that time that bore more resemblance to the 1969 Act's provisions than to those that were ultimately enacted in 1950. Among other proposals, Ways and Means advocated a blanket prohibition on foundations entering into financial transactions with certain related people or entities, a tax on foundation investment income that was not distributed for charitable purposes, and a denial of the donor's charitable deduction if he contributed a family-controlled business to his foundation.[45] The Committee's explanation largely echoed Snyder's concerns:

> Frequently families owning or controlling large businesses set up private trusts or foundations to keep control of the business in the family after death . . . . To prevent the avoidance of income, estate, and gift tax liability in such cases, your committee's bill provides that no charitable deduction be allowed to a contributor for income, estate, and gift tax purposes if [the contributor and family members control the recipient organization and also control the corporation the stock of which is contributed] . . . . Your committee believes that denial of

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43 *Revenue Revisions of 1950: Hearing on H.R. 8920 Before the Comm. on Fin.*, 81st Cong. 19 (1950) (statement of Hon. John W. Snyder, Secretary of the Treasury).

44 *Id.*

45 Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 Exempt Org. Tax Rev. 52, 53 (2000).

> deductions in such cases is simply a recognition of the fact that where such control exists no completed gift for which a deduction should be granted has been made.[46]

While the House of Representatives approved the bill as drafted, the Senate Finance Committee made substantial alterations.[47] The blanket prohibition on related-party transactions was deleted; such transactions would be permissible if made at arm's length.[48] The proposed tax on undistributed foundation income and the denial of a charitable deduction for contributions of family businesses were removed.[49] Ultimately, the Conference Committee tasked with reconciling the two bills adopted the Senate's provisions, but included in the legislation denials of exemption when a foundation accumulated, rather than distributed, income in unreasonable amounts or for an unreasonably long period, and when income was either not used for exempt purposes or invested in a manner that would jeopardize the foundation's charitable purposes.[50] As one commentator put it, "the restrictions on private foundations that emerged from the 1950 legislative process were, then, quite modest."[51]

D. Anticipating the 1969 Tax Reform Act

The 1950 legislation did little to quell public and Congressional concern about private foundations. Well-publicized news reports continued to showcase the tax and business-control benefits of foundations that had provoked criticism over the previous decades. A *Business Week* article from May 7, 1960, which the Treasury Department would ultimately cite in its landmark 1965 study of private foundations, explicitly recommended using a foundation to pass a family business to heirs without generating estate tax and without relinquishing control over the business. The article noted:

> The real motive behind most private foundations is keeping control of wealth (even while the wealth itself is given away). Take the typical case. Say the bulk of your property is in a family business. When you die, if you have a high-bracket estate, the estate tax could cause a forced sale of part or even all of the business — your children might lose control of the company, as well as have to sell their shares at a poor price. A foundation can prevent this. You set it up, dedicated to charity.

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46 COMM. ON WAYS & MEANS H.R., REVENUE ACT OF 1950, H.R. REP. NO. 81-2319, at 43-44 (1950).

47 *See* Troyer, *supra* note 45, at 53.

48 *Id.*

49 *See id.*

50 *Id.* at 53-54.

51 *Id.* at 54.

> Year by year, you make gifts of company stock to it, until the value of your remaining holdings is down to the point where eventual estate taxes could be paid without undue strain, or until the foundation's holdings constitute firm control of the company. You maintain control of the foundation while you live; you direct its charitable activities — and so, indirectly, you control the shares in your company that have been donated. When you die, control of the foundation passes from you to your family or other persons you trust and thus they, in turn, keep reins on the business.[52]

The article continued, advocating the "purely personal 'advantages'" of a private foundation: "You and your family members can deal privately with your foundation provided the transactions can be considered to improve its income or asset position."[53] These were precisely the concerns that, theoretically, Congress's 1950 legislation sought to address. Apparently, the legislation had not had its intended effect.

Four subsequent legislative developments lay the groundwork for the 1969 legislation. First, the House of Representatives established the Select Committee to Investigate Tax-Exempt Foundations and Comparable Organizations in 1952. The Select Committee, known as the Cox Commission (after its chairman, Edward Cox, a Democratic member of the House of Representatives from Georgia), had an anti-Communist agenda: it was tasked with determining which foundations "are using their resources for purposes other than the purposes for which they were established and especially to determine which . . . are using their resources for un-American and subversive activities or for purposes not in the interest or tradition of the United States . . . ."[54] Unfortunately for the suspicious Congressmen who issued its mandate, the Cox Commission's report concluded that foundations played a largely beneficial role in American society, identifying foundations as leaders in expanding the "frontiers of knowledge";[55] contributing to advancements in medicine and public health and "elevating medical education in this country to a position of world eminence";[56] "raising the level of education in our colleges and universities";[57] and making "equally significant" contributions to "natural sciences," "international relations, public administration and government, the humanities, race relations, the arts,

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52 *Personal Business*, Bus. Week, May 7, 1960, at 153, 153.

53 *Id.* at 153-54.

54 H.R. Rep. No. 82-2514, at 2 (1953).

55 *Id.* at 3.

56 *Id.* at 4.

57 *Id.*

adult education, recreation, and economics."[58] In fact, of the two significant recommendations that the Cox Commission made, one of them was for Congress to legislate in a manner that would *encourage* the growth of private foundations, given what the Commission viewed as their salutary influence on American society.[59] The stark difference between the Cox Commission's recommendations, on the one hand, and those of the next Congressional committee to be commissioned on the topic and Congressman Wright Patman's influential reports on private foundations from the 1960s, discussed below, on the other, are an apt illustration of the dueling undercurrents of support and suspicion of private philanthropic endeavors that date back to the country's founding.

Unsurprisingly, Congress was unsatisfied with the Cox Commission's report, and commissioned the Reece Committee (so known because its chair was B. Carroll Reece, Republican member of the House of Representatives from Tennessee) in 1954, which ultimately did allege that certain foundations had Communist sympathies.[60] The Reece Committee expressed broader concern with the operations of private foundations. It found that foundations' managers showed "little implementation of . . . responsibility to the general welfare," and that "the foundations administer their capital and income with the widest freedom, bordering at times on irresponsibility."[61] The report contended that foundations exerted undue influence on the field of social sciences; that they had the potential to "exercise various forms of patronage which carry with them elements of thought control," including by influencing educational institutions; that they had a disconcerting ability to influence national policy; and that they had infiltrated the media such that criticism of foundations was no longer possible,[62] an ironic comment given the history of public and Congressional criticism of foundations' operations. The Committee recommended enacting a legislative definition of private foundations, granting public access to foundations' annual reports, allowing foundations more time to distribute their income to ensure that grants were made properly and with charitable aims in mind, requiring foundations' boards to have a government-

58 *Id.*

59 *Id.* at 13. The other recommendation was for foundations to publicly account for their assets and activities. *Id.*

60 *See generally* H.R. Rep. No. 83-2681, pt. 2, at 54 (1954) (discussing several foundations' connections to Communism as shown by the Cox Committee and stating, "It is too much to assume that Communist success was limited to the exposed incidences. Indeed, where foundations are involved in so high a concentration of power . . . we may assume that some advantage may have been taken by the Communists . . . for malign purposes.").

61 *Id.* at 16.

62 *Id.* at 17-18.

appointed director, prohibiting control of businesses through foundations, and increasing the number of foundation audits.[63] A number of these recommendations would be reflected in the 1969 Tax Reform Act.

In the third significant legislative development of the immediate pre-Act period, Texas Congressman Wright Patman authored seven reports in the 1960s on the topic of private foundations.[64] He believed that wealthy Americans used foundations to take improper advantage of tax laws, control corporations, and unduly influence public policy.[65] His recommendations were far-reaching, including prohibiting the establishment of new private foundations, requiring private foundations to terminate 25 years after their establishment, establishing a national regulator for foundations, having the Treasury Department enforce the self-dealing rules more vigorously, implementing restrictions on foundations' commercial activities (including lending and borrowing money), limiting foundations to owning no more than 3% of the shares of any corporation, limiting foundations' ability to vote shares of a corporation, precluding donors from taking charitable deductions until contributions were actually spent, requiring all contributions to be spent as they were received, imposing a 20% income tax on foundations, and prohibiting foundations from engaging in certain voter registration activities.[66] Marcus Owens, formerly the director of the Exempt Organizations Division of the Internal Revenue Service and currently Partner at Loeb & Loeb LLP in Washington, D.C. in the area of nonprofit law, notes that "Patman, being a conservative Texas Democrat, had little use for highly-paid

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63 *Id.* at 213-17.

64 These reports were: (1) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., 87TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1962); (2) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 2, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1963); (3) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 3, 88TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1964); (4) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 4, 89TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1966); (5) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 5, 90TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1967); (6) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 6, 90TH CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1968); and (7) WRIGHT PATMAN, STAFF OF H. COMM. SMALL BUS., INSTALLMENT NO. 7, 91ST CONG., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print 1969).

65 Byrnes, *supra* note 23, at 563.

66 *Id.*

charities officials from New York City who wore fancy suits, like the Ford Foundation people. There was no small amount of animosity."[67]

Patman's reports were influential. In fact, Harvey Dale, University Professor of Philanthropy and the Law at NYU School of Law and the Director of the National Center on Philanthropy and the Law, contends that the "Patman hearings were probably the most important" motivation for the 1969 Tax Reform Act because they "led to the 1965 Treasury studies,"[68] a reference to the fourth major legislative development of the immediate pre-Act period: the Treasury Department's report on private foundations, commissioned in 1964 and issued on February 2, 1965.

The Treasury Department report was the Congressional fact-finding mission that had the most significant impact on what would ultimately become the 1969 Act. The Treasury Department evaluated foundation administration and governance using a sample size of 1,300 foundations.[69] The report both acknowledged the socially-beneficial effects of foundation-led programs and grant-making and recommended significant alterations to the law.

On the positive side, the Treasury Department found that "most private foundations act responsibly and contribute significantly to the improvement of our society."[70] Further, the Treasury Department emphasized the "special and vital role in our society" of private philanthropy, including in "areas into which government cannot or should not advance (such as religion)," as well as foundations' "unique[ ]" ability "to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly."[71] Because "even . . . those of relatively restricted means" could establish private foundations, private foundations served to "enrich the pluralism of our social order."[72]

While acknowledging the social benefits of foundations, the Treasury Department did find that "[s]erious abuses do exist among a minority of private foundations, and they require correction and restraint."[73] The report highlighted six areas in which Congressional action was warranted: self-dealing, delay in benefit to charity, foundations' involvement in business, families' use of foundations to control corporate

67 Telephone Interview with Marcus S. Owens, Partner, Loeb & Loeb LLP (June 3, 2019) [hereinafter Owens Interview].

68 Telephone Interview with Harvey Dale, U. Prof. Philanthropy & L., N.Y. Univ., Dir., Nat'l Ctr. on Philanthropy & L. (June 3, 2019) [hereinafter Dale Interview].

69 Treasury Report, *supra* note 4, at 77.

70 *Id.* at 13.

71 *Id.* at 5.

72 *Id*.

73 *Id.* at 14.

interests and other property, foundations' engaging in financial transactions unrelated to their charitable functions, and families' continued control of foundations' management over time.[74]

With respect to self-dealing, the Treasury Department report noted that transactions with a foundation's founder or donor "are rarely necessary to the discharge of the foundation's charitable objectives; and they give rise to very real danger of diversion of foundation assets to private advantage."[75] The 1950 legislation had imposed facts-and-circumstances and reasonableness tests to determine whether particular acts of self-dealing should be prohibited; these standards, the Treasury Department report contended, were imprecise and hard to administer. The report recommended, instead, a blanket prohibition on self-dealing transactions[76] — a recommendation that the 1969 Act would incorporate.[77]

Similarly, the Treasury Department noted that the "indefiniteness" of the law denying an exemption in the case of unreasonable accumulations of income and use of income in a way that jeopardized charitable purposes (or at least in a way that was not in promotion of charitable purposes) led to insufficient enforcement.[78] The report recommended that private foundations "be required to devote all of their net income to active charitable operations . . . on a reasonably current basis," with "a five-year carryforward provision and a rule permitting accumulation for a specified reasonable period if their purpose is clearly designated in advance and accumulation by the foundation is necessary to that purpose."[79] This recommendation, too, would be taken up in the 1969 Act.[80]

Echoing one of the most common criticisms of private foundations since the 1916 Walsh Commission report was published, the Treasury Department expressed significant concern about foundations' involvement in business and families' use of foundations to control these business interests. The report noted the "competitive disadvantage" of non-foundation-controlled businesses, due to the tax-favored treatment of foundations' assets; the potential for self-dealing inherent in foundations' ownership of businesses; and the concern that foundations' managers would be overly consumed with management of foundation-

74 *Id.* at 15-57.
75 *Id.* at 6.
76 *Id.*
77 Tax Reform Act of 1969, Pub. L. No. 91-172, § 4941(a)(1), 83 Stat. 487, 499; General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Cong., Pub. L. No. 91-172, 30-36 (1970).
78 TREASURY REPORT, *supra* note 4, at 7.
79 *Id.*
80 Tax Reform Act of 1969 § 4943(c)(6); H.R. 13270, Pub. L. No. 91-172, 56-57.

owned businesses.[81] The report recommended imposing "an absolute limit upon the participation of private foundations in active business" and suggested that a foundation should not be permitted to own 20% or more of a "business unrelated to the charitable activities of the foundation."[82] And when a donor to a foundation and related parties did maintain control of a business, the report recommended denying income tax deductions for transfers to the foundation until "(a) the foundation disposes of the contributed asset[s], (b) the foundation devotes the property to active charitable operations, or (c) donor control over the business or property terminates."[83] As described below, the 1969 Act accepted these recommendations in large part.[84]

The Treasury Department's final two recommendations were not implemented in the 1969 Act. First, the report recommended that "all borrowing by private foundations for investment purposes be prohibited," among other investment restrictions.[85] While certain investment restrictions — namely, the jeopardizing investment rules of what would become Internal Revenue Code section 4944 — were implemented, the Treasury Department's more draconian proposals were not. Similarly, the report recommended that after a certain period of time, the "donor and related parties would not be permitted to constitute more than 25 percent of the foundation's governing body."[86] This recommendation was not incorporated into the law. To this day, there is no requirement of independent management for foundations.

A few private foundations' highly publicized controversial acts ignited the powder keg of Congress's skepticism following the publication of the Treasury Department report. The Ford Foundation was a particular target. Teacher groups expressed outrage at the Ford Foundation's support of school decentralization in Brooklyn's Oceanhill-Brownsville school district.[87] In Cleveland's 1967 mayoral election, the Ford Foundation made grants to the Congress on Racial Equality to encourage African-Americans to register to vote; opponents of mayoral candidate Carl Stokes, who was ultimately elected as Cleveland's first African-American mayor, were up in arms about the grants.[88] And after Senator Robert F. Kennedy's assassination, the Ford Foundation distributed grants to a number of former aides of his, provoking allegations of "political

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81 Treasury Report, *supra* note 4, at 7.

82 *Id.*

83 *Id.* at 8.

84 *See infra* Part II.D.

85 Treasury Report, *supra* note 4, at 9.

86 *Id.* at 9-10.

87 *See* John G. Simon, *The Regulation of American Foundations: Looking Backward at the Tax Reform Act of 1969*, 6 Voluntas 243, 244 (1995); Troyer, *supra* note 45, at 60.

88 Troyer, *supra* note 45, at 60.

favoritism" and personal patronage[89] without "intellectual benefit."[90] Owens noted that some of these grant recipients "were reportedly photographed on yachts on the Aegean Sea."[91]

There is real debate on how widespread these controversial acts were. Owens notes that "there was anecdotal evidence" of "actual abuses," but "how common those were was another matter because the IRS audit program was not particularly extensive or systematic in those days."[92] Dale notes that "legislation can derive from a small number of anecdotes. I'm pretty sure that that was the case in 1969, though [in that case, it was not a] tiny number of anecdotes."[93] Regardless of how many foundations were engaged in conduct that was perceived as controversial or problematic, the public's and Congress's attention had been tuned to the issue. John Sare, Partner in the Tax-Exempt Organizations practice and the Trusts and Estates group of Patterson Belknap Webb & Tyler LLP in New York, notes that "there were enough perceived abuses in the world of family foundations that they were the subject of two popular novels of the day": Kurt Vonnegut's *God Bless You, Mr. Rosewater*, which eventually became an Off-Broadway musical, and *How Firm a Foundation* by Patrick Dennis. Sare adds:

> There was a widespread sense in the popular culture that foundations were places where a rich patron could provide a job for people who weren't capable of doing anything else and could indulge in activities of dubious philanthropic value. This may or may not have been true, of course, but the perception was still there.[94]

Ultimately, this public perception mattered more than how widespread these abuses actually were (which, as Owens points out, may have been impossible to discern), and the stage was set for the 1969 Tax Reform Act.

II. The Tax Reform Act of 1969

The Treasury Department report laid the groundwork for the provisions that were ultimately enacted as part of the Tax Reform Act of 1969. In fact, parts of the Act's legislative history mirror, almost verbatim, passages from the Treasury Department's report. The provisions

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89 John R. Labovitz, *The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements*, 3 J. Legal Stud. 63, 67 (1974).

90 Smith & Chiechi, *supra* note 3, at 44.

91 Owens Interview, *supra* note 67.

92 *Id.*

93 Dale Interview, *supra* note 68.

94 Telephone Interview with John Sare, Partner, Patterson Belknap Webb & Tyler LLP (June 11, 2019) [hereinafter Sare Interview].

that were ultimately enacted constitute the most significant, and most stringent, regulations governing the operations of private foundations in American history, and, over 50 years later, most still remain in effect as passed. This Part reviews the highlights of the Act.

A. Section 4940: Net Investment Income Tax

Internal Revenue Code section 4940 imposed a 4% tax on the net investment income of all private foundations, with the ostensible purpose of funding the IRS's private foundation audits.[95] In 1978, the 4% tax was reduced to a 2% tax, with the possibility of a further reduction to a 1% tax for private foundations that could demonstrate having made a certain average percentage payout over the preceding 5 years and having used the 1% savings to make additional qualifying charitable distributions.[96] In 2019, the rate was further revised to a flat 1.39%, without the possibility of further reduction.[97]

Congress explicitly tied the resulting revenue to the audit function. The House Ways and Means Committee's explanation noted that "it is clear that vigorous and extensive administration is needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes. This tax, then, may be viewed as being in part a user fee."[98] The staffs of the House's Joint Committee on Internal Revenue Taxation and the Committee on Finance agreed: "[F]unds are needed for more and more extensive and vigorous enforcement of the tax laws relating to foundations. A user fee is needed to provide funds for this purpose."[99] The Senate Finance Committee's report concurred: "[T]he costs of [IRS] supervision should not be borne by the general taxpayer, but rather should be imposed upon those exempt organizations whose activities have given rise to much of the need for supervision."[100] The new tax should be understood, the Senate Finance Committee contended, "as a supervisory fee and as an indication of the amount of funds needed by the Internal Revenue Service for proper administration of the Internal Revenue Code

95 Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 498.

96 Revenue Act of 1978, Pub. L. No. 95-600, § 520(a), 92 Stat. 2763, 2884.

97 Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, § 206(a), 133 Stat. 2534, 3246 (codified as amended at I.R.C. § 4940(a)).

98 COMM. ON WAYS & MEANS H.R., TAX REFORM ACT OF 1969, H.R. REP. NO. 91-413, pt. 1, at 19 (1969) [hereinafter WAYS & MEANS COMMITTEE REPORT].

99 STAFFS J. COMM. ON INTERNAL REVENUE TAX'N & COMM. ON FINANCE, 91ST CONG., SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969 (AS PASSED BY THE HOUSE OF REPRESENTATIVES) 11 (Comm. Print 1969) [hereinafter JOINT COMMITTEE REPORT].

100 S. COMM. ON FIN., TAX REFORM ACT OF 1969, S. REP. NO. 91-552, at 27 [hereinafter SENATE FINANCE COMMITTEE REPORT].

provisions relating to private foundations and other exempt organizations."[101] Based on the legislative history, the clear intent of section 4940, then, was to raise funds that would support the IRS's audits of private foundations.

Despite bicameral agreement on the net investment income tax constituting an "audit fee," neither Congress nor the IRS subsequently earmarked the funds for that purpose. Instead, as will be discussed, the funds continue to flow into the general Treasury coffers. Applying these funds for their intended purposes, this article will argue, would go a long way toward redressing some of the problems that plague the private foundations sector today.[102]

B. Section 4941: Self-Dealing Prohibitions

Internal Revenue Code section 4941[103] imposed a two-tier excise tax on all self-dealing transactions (i.e., transactions between the foundation at issue and a so-called "disqualified person," which, generally speaking, is defined as a substantial contributor to the foundation, a family member of a substantial contributor, or another controlling party).[104] This provision had the effect of prohibiting any such transaction — even a transaction that would ultimately have benefited the subject foundation.

Originally, section 4941 imposed a 5% tax on the "amount involved"[105] in the self-dealing transaction, payable by the disqualified

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101 *Id.*

102 *See infra* Part IV.

103 Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 498.

104 Section 4946 contains the definition of "disqualified person": a substantial contributor to the foundation; a foundation manager; an owner of more than 20% of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation; a member of the family of any of these individuals; a corporation of which any of the foregoing individuals owns more than 35% of the total combined voting power; a partnership in which any of the foregoing individuals owns more than 35% of the profits interest; and a trust or estate in which any of the foregoing individuals holds more than 35% of the beneficial interest. I.R.C. § 4946(a). For purposes of the self-dealing rules, government officials are also included. *Id.* § 4946(a)(1)(I). For purposes of the excess business holdings rules, discussed in Part II.D, *infra*, a private foundation that is effectively controlled by the same person or persons who control the private foundation in question, or substantially all of the contributions to which were made by the same individuals or members of their families who made substantially all of the contributions to the private foundation in question, is also included. *Id.* § 4946(a)(1)(H).

105 The "amount involved" is defined as "the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received; except that, in the case of services described in subsection (d)(2)(E), the amount involved shall be only the excess compensation." I.R.C. § 4941(e)(2).

person who participated in an act of self-dealing, and a 2.5% tax on a foundation manager who knew that the act was prohibited and permitted it to proceed anyway. These thresholds were increased in 2006 to 10% and 5%, respectively.[106] Section 4941 imposes additional taxes if the self-dealing is not corrected by a certain time: 200% of the amount involved on the self-dealing party and 50% of the amount involved on a knowingly participating foundation manager.[107] The thresholds for tax on a foundation manager were, and are, subject to certain caps.[108]

Congress intended these provisions as a direct response to the legacy of the 1950 legislation. The House Ways and Means Committee, Joint Committee, and Senate Finance Committee agreed with the Treasury Department that the arm's-length standards imposed in the 1950 law had become unworkable. Ways and Means, for instance, indicated that these standards "require disproportionately great enforcement efforts, resulting in sporadic and uncertain effectiveness of the provision," and still may confer improper benefit on the foundation's donors and managers.[109] Ways and Means cited a few examples of transactions giving rise to possibly improper benefits:

> [W]here 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 access to cash and cannot find a ready customer; (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 readily to find an alternative source 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.[110]

The Joint Committee and Senate Finance Committee reports contain virtually identical language.[111] Apparently, because Congress concluded

106 Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212(a)(1), 120 Stat. 780, 1074 (codified as amended at I.R.C. § 4941(a)).

107 I.R.C. § 4941(b).

108 *Id.* § 4941(c)(2) ("With respect to any one act of self-dealing, the maximum amount of the tax imposed by subsection (a)(2) shall not exceed $20,000, and the maximum amount of the tax imposed by subsection (b)(2) shall not exceed $20,000.").

109 WAYS & MEANS COMMITTEE REPORT, *supra* note 98, at 20.

110 *Id.* at 20-21.

111 *See* JOINT COMMITTEE REPORT, *supra* note 99, at 12 ("Arm's-length standards have proved to require disproportionately large enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. . . . Also, many benefits may be derived by those who control a private foundation even though they deal completely at arm's length."); SENATE FINANCE COMMITTEE REPORT, *supra* note 100, at 28-29. ("Arm's-length standards have proved to require disproportionately great enforcement efforts,

that the enforcement mechanism would never be sufficient to police individual transactions — an irony given Congress's parallel enactment of an audit-fee tax in section 4940 — Congress concluded that the only way to eliminate improper benefit was to prohibit, through section 4941, any transactions that could conceivably give rise to it.

C. Section 4942: Required Minimum Distributions

Internal Revenue Code section 4942[112] imposed a requirement that a foundation distribute annually for charitable purposes, at minimum, 6% of the foundation's net investment income (reduced to 5% in 1976),[113] which requirement took effect following the application of certain transition rules designed to facilitate compliance in the years immediately following the Act's passage.[114] If a foundation's distributions fall short of this threshold, the Act imposed an additional 15% tax on the amount of undistributed net income (increased to 30% in 2006),[115] and if not corrected in a certain period, an additional 100% tax on the undistributed amount.[116]

These rules were designed to respond to the Treasury Department report's concerns about a delay in charitable recipients benefiting from foundations' funds, as the 1950 law required only that accumulations of assets not be unreasonable.[117] As Ways and Means indicated, "Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes. As a result, while the donor may receive substantial tax benefits from his contribution currently, charity may receive absolutely no current benefit."[118] The Joint Committee and Senate Finance Committee reports echo this rationale.[119] Ultimately, these rules appear to have had

resulting in sporadic and uncertain effectiveness of the provisions. . . . [T]he committee has concluded that even arm's-length standards often permit use of a private foundation to improperly benefit those who control the foundation.").

112 Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 503 (codified as amended at I.R.C. § 4942(e)(3)).

113 Tax Reform Act of 1976, Pub. L. No. 94-455, § 1303(a), 90 Stat. 1520, 1715 (codified as amended at I.R.C. § 4942(e)(1)).

114 *See* Tax Reform Act of 1969 § 101(b).

115 Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212(b), 120 Stat. 780, 1074 (codified as amended at I.R.C. § 4942(a)).

116 Tax Reform Act of 1969 § 101(b), 83 Stat. 487, 502, 503.

117 *See* Treasury Report, *supra* note 4, at 11.

118 Ways & Means Committee Report, *supra* note 98, at 25.

119 *See* Joint Committee Report, *supra* note 99, at 13 ("Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes, even though the donor has received full deductions for the value of the nonincome-producing property he has contributed."); Senate Finance Committee Report, *supra* note 100, at 35 ("Under present law, if a private foun-

a salutary effect, at least on public confidence in private foundations and their operations, as will be discussed.[120]

D. Section 4943: Excess Business Holdings Prohibitions

Internal Revenue Code section 4943[121] imposed a 5% excise tax on so-called "excess business holdings," i.e., interests in a business enterprise that exceeded certain minimum thresholds following the expiration of a permitted divestment period.[122] The 5% tax was increased to 10% in 2006.[123] The sum of the foundation's holdings and the holdings of all disqualified persons in a given business enterprise may not exceed 20% of the enterprise's voting stock, or 35% if it can be demonstrated that unrelated parties control the business enterprise.[124] The provision imposed a *de minimis* safe harbor: a foundation was permitted to own up to 2% of the voting stock in a business enterprise.[125]

Echoing the Treasury Department's report, Ways and Means, the Joint Committee, and the Senate Finance Committee all expressed concern about the effect that business ownership had on foundation management and dedication to charitable purposes. As Ways and Means put it,

> Those who wish to use a foundation's stock holdings to retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. Even when the foundation attains a degree of

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dation invests in assets that produce no current income, then it need make no distributions for charitable purposes. As a result, while the donor may receive substantial tax benefits from his contribution currently, charity may receive absolutely no current benefit.").

120 *See infra* Part III.A.

121 Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 507 (codified as amended at I.R.C. § 4943(a)(1)).

122 "Excess business holdings" are defined as the excess holdings in an entity over the so-called "permitted holdings" threshold; the "permitted holdings" threshold, in turn, is defined as 20% of the voting stock in an incorporated business enterprise, reduced by the percentage of the voting stock owned by all disqualified persons. If the private foundation and all disqualified persons, combined, do not own more than 35% of the voting stock of an incorporated business enterprise, and non-disqualified persons effectively control the enterprise, then the threshold for permitted holdings is raised to 35%. In all events, a private foundation may hold up to 2% of the voting stock in an incorporated business enterprise and up to 2% in value of all outstanding shares of all classes of stock. I.R.C. § 4943(c)(2). The Code and accompanying Treasury Regulations also contain rules for partnerships and other unincorporated entities. *See* I.R.C. § 4943(c)(3); Treas. Reg. § 53.4943-3(c).

123 Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212(c) 129 Stat. 780, 1074 (codified as amended at I.R.C. § 4943(a)(1)).

124 I.R.C. § 4943(c)(1), (c)(2)(A)-(B).

125 *Id.* § 4943(c)(2)(C).

> independence from its major donor, there is a temptation for the foundation's managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties.[126]

Ways and Means did acknowledge that certain adjacent businesses — such as "cafeterias and snack bars" at museums and, in a granular example, the Williamsburg Inn at Colonial Williamsburg — could be retained under the rules.[127] As will be discussed, given the trend toward professional foundation management, these rules may be antiquated, and, some contend, have been gutted by the so-called Newman's Own exception, enacted in 2017.[128]

E. Section 4944: Jeopardizing Investments

Internal Revenue Code section 4944[129] imposed a 5% tax, subject to certain caps, on amounts invested in a way that, by being excessively risky, jeopardizes the charitable purposes of the foundation at issue. This tax was increased to 10% in 2006.[130]

The Joint Committee pointed out that there was no penalty under then-current law for imprudent or overly speculative investment. "Under present law," the Joint Committee Report noted, "a private foundation manager may invest the assets (other than accumulated income) in warrants, commodity futures, and options, or may purchase on margin or otherwise risk the entire corpus of the foundation without being subject to any sanctions."[131] Because improperly invested funds

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126 Ways & Means Committee Report, *supra* note 98, at 27; *see also* Joint Committee Report, *supra* note 99, at 15 ("The use of foundations to maintain control of businesses appears to be increasing. Whether or not the foundation management is independent of donor control, incentive to control a business enterprise frequently detracts from incentive to produce and use funds for charitable purposes. Temptations are frequently difficult to measure and sanctions presently are applied only in rare cases."); Senate Finance Committee Report, *supra* note 100, at 38-39 ("The use of foundations to maintain control of businesses appears to be increasing. It is unclear under present law at what point such noncharitable purposes become sufficiently great to disqualify the foundation from exempt status. . . . Those who wish to use a foundation's stock holdings to acquire or retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. In fact, they may become so interested in making a success of the business, or in meeting competition, that most of their attention and interest is devoted to this with the result that what is supposed to be their function . . . is neglected.").

127 Ways & Means Committee Report, *supra* note 98, at 43.

128 *See infra* text accompanying notes 219-22.

129 Tax Reform Act of 1969, Pub. L. No. 91-172, § 101(b), 83 Stat. 487, 511.

130 Pension Protection Act of 2006, Pub. L. No. 109-280, § 1212(d), 129 Stat. 780, 1074 (codified as amended at I.R.C. § 4944(a)(1)).

131 Joint Committee Report, *supra* note 99, at 16.

would lead to diminished amounts being used for charitable purposes, there was reason to penalize foundation managers who did not invest wisely. As discussed below, while these rules have been some of the least controversial components of the 1969 Act, alternatives to foundations have gained traction in part because they are not subject to these investment requirements.

F. Section 4945: Taxable Expenditures

Internal Revenue Code section 4945[132] was a direct response to the political activities in which foundations engaged in the years leading up to the Act.[133] It imposed a 10% tax on amounts spent on political activities payable by the private foundation, plus a 2.5% tax on the participating foundation manager (increased to 20% and 5%, respectively, in 2006).[134] If the offending distributions were not corrected within a certain period, the Act imposed a 100% tax on the foundation and a 50% tax on the foundation manager, again subject to certain caps.[135] It also increased the due diligence requirements for grants to individuals and foreign charities (known as "expenditure responsibility"),[136] which ultimately had the effect of deterring foundations from making these grants, irrespective of need.[137]

Without mentioning particular examples of political or legislative activities that it found problematic, Ways and Means nonetheless addressed itself squarely to the Ford Foundation. The Committee's explanation noted,

> It . . . was called to your committee's attention that existing law does not effectively limit the extent to which foundations can use their money for "educational" grants to enable people to take vacations abroad, to have paid interludes between jobs, and to subsidize the preparation of materials furthering specific political viewpoints.[138]

The Committee further derided foundations' "financing registration campaigns."[139] As is the case with the jeopardizing investments rules, the section 4945 prohibitions have been among the least controversial of

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132 Tax Reform Act of 1969, § 101(b) (codified as amended at I.R.C. § 4945).

133 *See supra* text accompanying notes 87-91.

134 Pension Protection Act of 2006 § 1212(e)(1) (codified as amended at I.R.C. § 4945(a)(1)).

135 I.R.C. § 4945(b).

136 *Id.* § 4945(h).

137 *See infra* text accompanying notes 167-69.

138 Ways & Means Committee Report, *supra* note 98, at 33.

139 *Id.* at 32. The Senate Finance Committee and Joint Committee reports expressed concern about similar issues, though with less explicit references to the Ford Foundation's

the 1969 Act's provisions; however, the fact that foundation alternatives are not subject to these rules has almost certainly provided a boost to these alternatives.

III. The Legacy of the 1969 Tax Reform Act

The private foundation governance provisions of the 1969 Tax Reform Act have remained largely unchanged since their passage, and they have been the subject of relatively few litigated cases. The past half-century, then, represents a useful time period over which to assess the legacy of the rules.

Unquestionably, foundations have boomed since the Act was passed, both in terms of the number of active foundations and the fair market value of foundation assets. As Bruce Hopkins, who practices in the field and teaches the subject as Professor from Practice at the University of Kansas School of Law, notes, "[a] lot of people said that" the Act marked "the end of private foundations."[140] The statistics show otherwise. At the time of the Treasury Report, approximately 15,000 private foundations existed,[141] with assets of approximately $16.26 billion[142] (around $134.7 billion in today's dollars);[143] as of 2016, 100,488 private foundations filed annual returns with the IRS,[144] with collective foundation assets at a fair market value of nearly $890 billion.[145] While we cannot determine how foundations would have fared absent the Act's passage, these statistics certainly disprove the dire predictions.

While the new rules have had certain salutary effects — interviewees largely agreed, for instance, that foundations were perceived as "cleaning up their acts" after the Act's passage due to increased IRS scrutiny, required divestments resulting from the excess business holdings rules, and the minimum payout requirement — the overwhelming consensus is that foundations have thrived in spite of, and not because of, the Tax Reform Act. This Part will assess the legacy of the Act over the past 50 years, highlighting both the positive and negative consequences, and will demonstrate how the Act has, ironically, jeopardized the prospect of foundations continuing to provide the social benefit that they have since the Gilded Age. This Part will further evaluate the rise

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activities. *See* Senate Finance Committee Report, *supra* note 100, at 47-48; Joint Committee Report, *supra* note 99, at 17.

140 Telephone Interview with Bruce Hopkins, Professor of Prac., Univ. of Kan. Sch. L. (June 13, 2019) [hereinafter Hopkins Interview].

141 Treasury Report, *supra* note 4, at 74 tbl.7, 79 tbl.10, 83 tbl.11.

142 *Id.* at 74 tbl.7.

143 U.S. Inflation Calculator, *supra* note 4.

144 Internal Revenue Serv., Table 1, *supra* note 4.

145 *Id.*

of alternatives to foundations that have become increasingly popular, focusing on donor-advised funds and section 501(c)(4) social welfare organizations, which threaten to neuter the power of private philanthropy.

A. Positive Consequences of the Rules

The Act's provisions have shaped foundation behavior in certain positive ways. In the immediate post-Act period, the IRS stepped up its enforcement efforts, and audits of foundations became increasingly likely. The mere possibility of an audit, "coupled with actual audits" and "the attendant buzz at conferences," Owens notes, as well as the IRS's "pumping out a considerable number of revenue rulings in the 1970s" on the subject of private foundations, created a perception among foundation managers that the IRS was paying close attention to their activities.[146] This perception, Owens contends, "went a long way toward encouraging voluntary tax compliance."[147]

In addition to the prospect of an audit, the excess business holdings rule also appears to have positively shaped foundations' behavior in a manner that, arguably, has made the rule obsolete. Because foundations were required to divest themselves of excess business holdings immediately after the Act's passage and diversify their portfolios, foundation management became increasingly professionalized. As Jill Manny, Executive Director of the National Center on Philanthropy and the Law and adjunct professor at NYU School of Law, notes, "The excess business holdings rule had a lot to do with [getting] people focused on running foundations and not running businesses."[148] No longer could foundations simply employ family members who, theoretically, might prioritize the financial health of a particular foundation-owned business enterprise over charitable goals. Instead, foundations increasingly hired professional investment and compliance teams. Manny explains that now, "[y]ou're not going to have a foundation manager running a business" because "they're both big jobs."[149] Hopkins concurs, citing the divestments required by the excess business holdings rule as positively shaping behavior toward professionalization and, in that way, rendering the rule "antiquated."[150]

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146 Owens Interview, *supra* note 67.

147 *Id.*

148 Telephone Interview with Jill Manny, Exec. Dir., Nat'l Ctr. on Philanthropy & L., Adjunct Professor, N.Y. Univ. Sch. L. (June 11, 2019) [hereinafter Manny Interview].

149 *Id.*

150 Hopkins Interview, *supra* note 140. One may argue that eliminating or making more permissive the bright-line test of the excess business holdings rule would bring us back to the pre-Act landscape in which foundation managers may have been unduly focused on running related operating businesses. However, given the current business landscape, it is highly unlikely that foundation managers, rather than the governing bodies of

Finally, the minimum payout requirement ensured, for the first time, that foundations would dispense funds in support of charitable causes. Before Congress imposed the minimum payout requirement, there was a real concern, as Martin Hall, Partner in the Private Client group of Ropes & Gray LLP in Boston, notes, of "assets being parked, a benefit flowing to the taxpayer-donor and no benefit being returned to society at large through charitably funded activity."[151] But the imposition of the new requirement, Sare notes, "has provided a lot of assurance to the public and to many critics of the philanthropy sector that foundations aren't just stockpiling their resources."[152] The minimum payout requirement, then, directly remedied the problem of delayed benefit to charity that the Treasury Report and Congress focused on in the pre-Act period.[153]

In these respects, then, the Act has had positive effects on the private foundation landscape. However, these particular benefits have not been sufficient to cement public confidence in private foundations, and certain aspects of the rules have had the paradoxical effect of limiting the degree to which charity benefits from private foundations' operations.

B. Negative Consequences of the Rules

Apart from these positive effects, the Act's legacy has not been rosy. As Ray Madoff, professor in the areas of philanthropy policy, tax, property, and estate planning at Boston College Law School, notes,

> The whole purpose of this system was to maximize the interest in value of nonprofits, and to get resources released from donors and committed to nonprofits. It's 50 years later. There's no question that the rules aren't working. I don't think you'd find a single person who thinks the rules are working.[154]

Charles "Skip" Fox IV, Partner in the Tax & Employee Benefits department and the Private Wealth Services group of McGuireWoods LLP in Charlottesville, Virginia, and former President of the American College

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the businesses themselves, would run such businesses. Further, foundation management has essentially become a profession unto itself; it is hard to imagine that profession simply disappearing due to a relaxation of the excess business holdings restrictions.

151 Telephone Interview with Martin Hall, Partner, Ropes & Gray LLP (June 6, 2019) [hereinafter Hall Interview]; *see supra* Part II.C.

152 Sare Interview, *supra* note 94.

153 *See supra* Part II.C. Ironically, the current popularity of donor-advised funds, or DAFs, threatens to revive this very issue. *See* Cullman & Madoff, *supra* note 14; *see infra* Part III.B.5.

154 Telephone Interview with Ray Madoff, Professor, Bos. Coll. L. Sch. (June 10, 2019) [hereinafter Madoff Interview].

of Trust and Estate Counsel, concurs, reflecting, “Honestly,” there have been “no positive consequences” of the rules.[155] The complexity of the law, the lack of dialogue between foundations and IRS regulators, and the overinclusive nature of the bright-line rules imposed by the Act have engendered a lack of public confidence in the regulatory regime. Cumulatively, these flaws have led philanthropists to seek ways to avoid the restrictions entirely by creating organizations of different types, undermining Congress’s aims in promulgating the restrictions.

1. *Undue Complexity*

Practitioners and academics agree that the single most significant source of the rules’ negative consequences is their undue complexity. Most foundations fully intend to follow the rules. As Jackie Ewenstein, Partner at Ewenstein & Roth LLP in New York specializing in nonprofit law, notes, “The vast majority of our clients really, genuinely want to comply with the law.”[156] Hopkins agrees: “In my own practice, most of what I see are people who are really trying to comply with the statute.”[157] But the complexity of the rules is legendary. Hall described the rules as “unfair,” adding, “While a high hurdle for eligibility for the tax benefit seems appropriate, the setting of traps for the unwary does not.”[158] Ewenstein agrees, noting that where foundations “trip up, it’s because the law is so complicated that” their missteps are “really inadvertent.”[159] Complexity, then, is a primary problem.

Those foundations that lack the resources to hire the most sophisticated legal counsel risk running afoul of the rules despite their best intentions. Hopkins notes, “The ’69 Act created a lot of work for a lot of lawyers. When I started to practice law in 1968, people didn’t even know what a nonprofit lawyer was. Today, of course, it’s a major practice area.”[160] The rules are so complex, Manny notes, that “There’s really only a handful of lawyers who understand all of these rules.”[161]

Because those lawyers who do have a solid grasp of the rules typically charge among the highest rates in the field, foundations have a choice: pay the going rate or attempt to navigate the rules on their own. Many foundations choose the former, contributing substantially to an explosion in administrative costs. Peter Frumkin notes that, between

155 Telephone Interview with Charles “Skip” Fox IV, Partner, McGuireWoods LLP (May 31, 2019) [hereinafter Fox Interview].
156 Telephone Interview with Jackie Ewenstein, Partner, Ewenstein & Roth LLP (July 9, 2019) [hereinafter Ewenstein Interview].
157 Hopkins Interview, *supra* note 140.
158 Hall Interview, *supra* note 151.
159 Ewenstein Interview, *supra* note 156.
160 Hopkins Interview, *supra* note 140.
161 Manny Interview, *supra* note 148.

1966 and 1972, "average administrative foundation expenses as a percentage of grant outlays increased from 6.4% to 14.9%."[162] From 1966 to 1978, "[t]he Ford Foundation's administrative expenses as a percentage of grant outlays went from 2.3% . . . to 22.3%," and from 5.7% to 23.6% for the Carnegie Corporation.[163] And the explosion of administrative costs has continued: in 2016, the most recent year for which IRS data is available, foundations collectively reported paying more than $620 million in legal and accounting fees.[164] As Ewenstein notes, "Navigating the complicated laws requires expert counsel and attendant legal fees that otherwise could be redirected to charitable endeavors. There's a financial cost to the complicated legal regime."[165] A large portion of these funds could otherwise have been spent for charitable purposes. And private philanthropists who intend to establish relatively small foundations can be deterred from doing so at all, further resulting in reduced benefit to charity. Fox notes, "Unless you're planning to fund a private foundation with at least $10 million, compliance requirements will just kill you."[166] Paradoxically, then, rules designed in large part to maximize benefits to charity have had, in some ways, precisely the opposite effect.

For those foundations that choose the latter option, attempting to navigate the rules on their own can result in unduly conservative grantmaking. Manny points out, "The rules cause inaction. They cause people to make simple grants to the extent of their minimum distribution requirements to large public U.S. charities."[167] Unable to navigate the minefield of the expenditure responsibility rules, for instance, some foundations refuse to make grants to individuals or to any organization that is not a public charity.[168] As Frumkin writes, "caution has increasingly become an occupational necessity among foundation staffers."[169] If foundations are to step in where government retreats,[170] and continue their track record of targeted and successful programs, it is undesirable

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162 Frumkin, *supra* note 5, at 269.

163 *Id.* at 270.

164 INTERNAL REVENUE SERV., TABLE 3. DOMESTIC PRIVATE FOUNDATIONS: INCOME STATEMENTS AND BALANCE SHEETS, BY SIZE OF FAIR MARKET VALUE OF TOTAL ASSETS, TAX YEAR 2016, https://www.irs.gov/statistics/soi-tax-stats-domestic-private-foundation-and-charitable-trust-statistics#2. [https://perma.cc/493S-CADX].

165 Ewenstein Interview, *supra* note 156.

166 Fox Interview, *supra* note 155.

167 Manny Interview, *supra* note 148.

168 Simon, *supra* note 87, at 250.

169 Frumkin, *supra* note 5, at 274.

170 "In other countries," write Lewis B. Cullman and Ray Madoff,

> it is common for universities, hospitals, art museums, symphonies, and social safety nets to be funded by governments. In the U.S., charitable organizations, supported by tax-favored private donations, carry out many of the same social

to deter foundations from making grants to certain large groups of potential recipients simply because the rules are too complicated for most foundation managers to understand or because the penalties for noncompliance are imposed regardless of intent. As a corollary, funneling more assets to those public charities that are already among the largest in the country — which is the "safest" course of action, as far as many foundation managers are concerned — may be similarly undesirable; the impact of each additional dollar on the programs that those charities administer is likely to be substantially less significant than for newer or less-well-funded programs.

2. *Lack of Dialogue with the IRS*

The IRS could serve as a helpful resource for foundations, particularly in light of the complexity of the private foundation governance restrictions. Instead, it has become increasingly difficult to obtain any guidance at all in this area from the IRS, due at least in part to the fact that the IRS lacks the budget and staff to make representatives available for dialogue with foundation managers and the general public.

The amount of IRS guidance in this field has decreased dramatically from the amount it offered in the two decades immediately following the Act's passage. As Owens notes, in the 1970s and 1980s, "there was a lot more guidance than there is now."[171] As Technical Advisor to the Exempt Organizations Division in the 1980s and, later, as Director of the Division, Owens made public the annual work plan, a memorandum describing audit projects and items of particular interest. That memorandum alerted practitioners to the areas on which the IRS was likely to focus for a particular period, which increased transparency and, Owens contends, drove "the behavior of practitioners" in a positive way.[172]

Not only has guidance become harder to come by, but audit activity has also been greatly reduced.[173] On the latter point, as Conrad Teitell, Principal in the Private Clients group at Cummings & Lockwood in Stamford, Connecticut, and adjunct law professor at the University of Miami School of Law, points out, "All the rules in the world can't stop people from" engaging in abusive behavior with private foundations "if

> functions. The American system depends on an adequate flow of private donations to working charities . . . .

Cullman & Madoff, *supra* note 14.

171 Owens Interview, *supra* note 67.

172 *Id.*

173 Telephone Interview with Conrad Teitell, Principal, Cummings & Lockwood LLC (June 4, 2019).

the IRS hasn't the time and the funds to go after these people."[174] Chronic underfunding of the IRS, then, may have enabled precisely those activities that the Act was designed to eliminate. In addition, the audit incentives are misaligned. As Hall contends, "In most cases, there is little incentive for the tax authorities to audit tax-exempt entities. The potential revenue that could be generated from such activity is minimal."[175] The combination of inadequate funding and minimal incentive has created the impression, then, that the IRS is unlikely to flag examples of foundation mismanagement. We will never know how much bad behavior goes undetected.

The unfortunate consequences of IRS underfunding and these misaligned incentives are not limited to effectively permitting prohibited activity. Were the IRS better funded, it could serve as a resource to assist foundations in facilitating *good* grant-making that is not unduly conservative, rather than simply enforcing rules about the grant-making and other operations that are prohibited. As Ewenstein notes,

> The real important thing is, are you doing good work with this money because we're giving you a tax break? But we're not assessing the organizations in terms of their effectiveness, and if they're not being any more effective than our government, some people have asked: why aren't we taxing them?[176]

But because the IRS does not even have the resources to audit suspicious activities, there is no possibility of the IRS serving as a resource to promote beneficial ones.

3. *Overinclusive Nature of Bright-Line Rules*

A number of the private foundation-related governance provisions enacted in 1969 impose penalties for violations regardless of the circumstances of the particular case at issue.[177] The self-dealing rules present a useful case study of the drawbacks of this approach, which precludes foundations from engaging in transactions that could be beneficial to them — and, ultimately, to the charitable causes they serve — and that pose no significant detriment to the public.

The benefit of the bright-line approach is, of course, its ease of administration. As Owens notes, the self-dealing rules "had the effect of taking off the table tough valuation questions. If you argue that you're

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174 *Id.*
175 Hall Interview, *supra* note 151.
176 Ewenstein Interview, *supra* note 156.
177 *See supra* Parts II.B (discussing the self-dealing rules), II.C (discussing the minimum distribution requirements), II.D (discussing the excess business holdings rules), and II.F (discussing the taxable expenditures rules).

providing the office space [to a foundation to which you are a substantial contributor] at half price, how do you figure out what half price is?"[178] Instead, under current law, no substantial contributor can lease office space for *any* rent to his or her foundation. Hall adds that, "from an implementation standpoint, . . . that makes sense. It's a smart approach, and avoids arguments over what is fair value and the like."[179] There is no question that a bright-line approach is easier for the IRS to administer. Particularly given the IRS's underfunding and lack of staff, imposing a facts-and-circumstances test — at least in the current climate — could result in significant under-enforcement of the rules.

However, commentators interviewed by the author almost uniformly pointed out that, from a policy perspective, adopting a bright-line test in this context is problematic. Prohibiting all transactions involving a foundation and particular parties, regardless of the substance of the transactions, may proscribe transactions that would have been beneficial to foundations and, correspondingly, would have directed additional funds to charitable causes. Manny notes, "The self-dealing rules are just totally prophylactic. They outlaw a lot of good philanthropy. Deals that might be favorable to foundations . . . can't be made."[180] Hopkins agrees: "[J]ust because it's easier to administer doesn't mean that it's fair or equitable."[181] In fact, while Congress deliberated the Act's provisions, the Joint Committee listed this very concern as one of its arguments against the proposed self-dealing rules:

> This provision would prohibit fair and equitable transactions even where they benefit charity. In addition, it seems unfair to prevent a donor from dealing with his foundation on the same terms that the foundation would be willing to deal with an unrelated person.[182]

The Joint Committee, then, foreshadowed one of the most significant criticisms of the 1969 Act's private governance-related provisions.

The Rockefeller Foundation's post-Act move to new office space is an illustrative example of the overinclusive nature of the self-dealing rules. Before the Act's passage, the Rockefeller Foundation leased office space in Rockefeller Center in New York City at a standard commercial rate.[183] Because of the self-dealing rules, however, the Rockefeller Foundation could no longer do so once the Act took effect,

178 Owens Interview, *supra* note 67.
179 Hall Interview, *supra* note 151.
180 Manny Interview, *supra* note 148.
181 Hopkins Interview, *supra* note 140.
182 Joint Committee Report, *supra* note 99, at 13.
183 Simon, *supra* note 87, at 250-51.

and moved to a different office space.[184] Reports noted the high expense of this move; one report identified it at $2 million,[185] or nearly $14 million in today's dollars.[186] These funds were not spent to advance charitable causes; instead, they enriched moving companies, architects, engineers, electricians, and furniture vendors, to name only a few. And the Rockefeller Foundation continued to pay commercial-rate rent — the only distinction was the identity of the landlord. It is hard to justify this diversion of funds that, pre-Act, could have been used for charitable purpose, particularly where the result for the foundation in expenditure of rental payments is, in terms of value, no different from what it was in the pre-Act period.

By contrast, in the public charities context, the IRS has adopted a reasonableness test in assessing whether certain transactions that potentially involve self-dealing may proceed,[187] suggesting that sufficient enforcement does not rely on having the easier-to-administer bright-line rules. Sare points out one distinction that may have led Congress to apply a facts-and-circumstances test, rather than a bright-line rule, to public charities' financial transactions: "[I]n the public charity context . . . there are ordinarily disinterested people on the board who can regulate" the public charity's activities, and so a public charity may be perceived to be less susceptible than a private foundation to engaging in transactions that benefit contributors and other insiders.[188] However, simply because private foundations may have family members on their boards does not mean that there is necessarily a higher probability of abuse inherent in such transactions. Furthermore, as discussed above, the increasing professionalization of foundation management in the decades following the Act has limited the relevance of this concern.[189]

Notably, there are mechanisms in place to mitigate the harshness of the self-dealing rules. Owens points out that the IRS has "the ability to settle cases so that if something did come up" where the imposition of the penalties would seem dramatically inequitable, the IRS could reduce the amounts owed.[190] Treasury Regulations have also carved out specific exceptions to the self-dealing rules. The estate administration exception to the self-dealing rules, for instance, permits an estate to engage in transactions that would otherwise constitute prohibited indirect self-dealing (for example, where a decedent's estate plan directs the distribu-

184 *Id.*

185 *Id.*

186 U.S. Inflation Calculator, *supra* note 4.

187 These transactions are referred to in the Code as "excess benefit transactions." *See* I.R.C. § 4958.

188 Sare Interview, *supra* note 94.

189 *See supra* text accompanying notes 148-50.

190 Owens Interview, *supra* note 67.

tion of the decedent's residuary estate to a private foundation, and the decedent's family wishes to purchase assets that would otherwise pass to the foundation).[191] This exception requires, among other factors, that the probate court with jurisdiction over the estate approve the transaction and that the foundation benefit from the transaction.[192] It was intended to "facilitate estate administration, permit the orderly administration of an estate or trust, and allow flexibility to shift assets to carry out the decedent's intent under a will or trust otherwise allowable under fiduciary state law principles."[193] Perhaps as an indicator that the Treasury Department knew early on that the bright-line nature of the self-dealing rules could prove problematic, this exception was implemented almost immediately following the Act's passage: proposed in 1971, it was finalized in 1973.[194]

These mitigating measures, however, do not give most commentators comfort that the bright-line nature of the self-dealing rules is sound policy. And from the standpoint of engendering public confidence in the regulatory regime, it is hard to imagine that imposing a bright-line standard with substantial penalties and then allowing the de facto flexibility to permit those who violate the general rules to settle or take advantage of certain carve-outs would have the desired effect.

4. *Continued Skepticism*

Congress and the public remain skeptical of private foundations. That skepticism is a result of both general unease about wealth inequality and specific rules in the private foundation governance regime that have the unintended consequence of undermining public confidence that private foundations are operating primarily for public benefit.

Legislative skepticism continues. Assuming the mantle of Senator Wright Patman,[195] Senator Charles Grassley, Republican of Iowa, has devoted considerable efforts to increasing the excise taxes on private foundations that violate the rules enacted in 1969.[196] Those efforts pro-

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191 *See* Treas. Reg. § 53.4941(d)-1(b)(1), (3).

192 *Id.* Note, however, that the IRS can still overrule the probate court's decision to permit a transaction to proceed. *See, e.g.*, Rockefeller v. United States, 718 F.2d 290, 291 (8th Cir. 1983) (affirming a finding by the IRS that the plaintiff had not in fact paid fair market value for the sold asset despite court approval).

193 Richard L. Fox, Charitable Giving: Taxation, Planning and Strategies ¶ 30.18(5)(b) (2020).

194 Treas. Reg. § 53.4941(d)-1(b)(1), (3).

195 *See supra* text accompanying notes 64-68.

196 *See, e.g.*, Press Release, Charles Grassley, Pro Tempore Emeritus, Senate, Grassley Outlines Goals for Charitable Governance, Transparency (Mar. 10, 2009), http://www.grassley.senate.gov/news/news-releases/grassley-outlines-goals-charitable-governance-transparency [https://perma.cc/96XA-MS3K]; Letter from Sen. Charles Grassley,

duced what one commentator characterizes as "a substantial discussion of the regulation of foundations during 2004-06," including the passage of the Pension Protection Act of 2006 that increased penalties for foundation noncompliance with certain rules,[197] and further "encouraged a significant IRS revision of Form 990 in 2009."[198] Just as Congress in the pre-Act period sought to increase foundation accountability and encourage better behavior through legislation, so has Senator Grassley done in more recent years.[199]

The public response to a private operating foundation[200] that opened in 2019, functions as a museum in New York and operates a study center in Greenwich, Connecticut evidences broader skepticism. An article in *The New York Times* following the museum's opening in New York noted that that foundation and several others that house privately-owned art collections constitute "private exhibition venues but also tax havens for the very rich."[201] A *Time Out New York* article expresses skepticism even more sharply:

Pro Tempore Emeritus, Senate, to Steve Gunderson, President and CEO, Council on Foundations (June 9, 2010), https://www.finance.senate.gov/imo/media/doc/letter%20to%20Council%20on%20Foundations.pdf.

197 *See, e.g.*, *supra* notes 106, 115, 123, 130, 134.

198 Steven Rathgeb Smith, *Foundations and Public Policy*, *in* AMERICAN FOUNDATIONS: ROLES AND CONTRIBUTIONS 371, 374 (Helmut K. Anheier & David C. Hammack eds. 2010). Form 990 is the annual return for charities; public charities file a regular Form 990 and private foundations file a Form 990-PF. *About Form 990, Return of Organization Exempt from Income Tax*, INTERNAL REVENUE SERV., https://www.irs.gov/forms-pubs/about-form-990 [https://perma.cc/75VL-66YE]; *About Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, INTERNAL REVENUE SERV., https://www.irs.gov/forms-pubs/about-form-990-pf [https://perma.cc/UF7Z-SMT6].

199 Publicly, at least, no member of Congress has taken up the "Charity Stimulus" plan to increase the minimum payout requirement for foundations and impose such a requirement on DAFs. *See, e.g.*, *infra* text accompanying footnotes 207-09.

200 A private operating foundation is a private foundation that spends at least 85% of the lesser of (i) its adjusted net income and (ii) its minimum investment return on actively conducting its charitable operations. It also has to meet one of three additional tests, known as the assets test, the endowment test, and the support test. *Definition of Private Operating Foundation*, INTERNAL REVENUE SERV., https://www.irs.gov/charities-non-profits/private-foundations/definition-of-private-operating-foundation [https://perma.cc/W8BV-HUSX]. In exchange for meeting these requirements, private operating foundations are not subject to the minimum distribution requirements, and thresholds for a donor's maximum tax-deductible contribution to a private operating foundation exceed those for a donor's contribution to a private foundation. *Private Operating Foundations*, INTERNAL REVENUE SERV., https://www.irs.gov/charities-non-profits/private-foundations/private-operating-foundations [https://perma.cc/DJ4F-ZWT6].

201 Martha Schwendener, *'Jean-Michel Basquiat' at the Brant Shows His Bifurcated Life*, N.Y. TIMES (Mar. 5, 2019), http://www.nytimes.com/2019/03/05/arts/design/basquiat-brant-foundation.html [https://perma.cc/J437-K2BT].

> Though New York gems like the Frick and the Morgan also began as the amassed treasures of titans of industry and finance, [the] . . . museum, housed in a retrofitted former Con Edison substation on an otherwise still-gritty block of East 6th Street, reads as a symbol of our city's ongoing gentrification, as well as an example of how culture has become a tool of social control for today's robber barons, not an act of noblesse oblige. Ultimately, this exhibition comes off as a rich man's bauble, which doesn't make for a good first impression.[202]

This criticism harkens back to the suspicion directed toward private philanthropy in the pre-Act period and, specifically, legislators' concerns that tax revenue was being diverted to support institutions that ultimately provided minimal social benefit.[203]

The public response to the efforts to reconstruct Notre Dame after the catastrophic fire of April 2019 evidences public skepticism about private philanthropy on a global level. Private philanthropists rushed to help, pledging and donating funds directly to the reconstruction effort.[204] Not all observers were pleased, however. Some questioned whether rebuilding Notre Dame represented a worthy use of charitable funds,[205] while others objected to the manner in which philanthropists helped, arguing "that for society to be most effective, philanthropists need to work with government and the private sector, not alone or in opposition to them."[206]

The public response to foundations' role in the COVID-19 pandemic represents yet another illustration of skepticism. Responding to the concern that "donors can contribute to charitable intermediaries [i.e., private foundations and DAFs] that then may sideline the funds for years — or forever" and that "ordinary taxpayers need to see the bene-

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202 Joseph R. Wolin, *Jean-Michel Basquiat*, TIME OUT N.Y. (Feb. 22, 2019), https://www.timeout.com/newyork/art/jean-michel-basquiat-1 [https://perma.cc/2E2C-LZ9F].

203 *See*, *e.g.*, Walsh Commission Report Vol. 1, *supra* note 29, at 81; COMM. ON WAYS & MEANS H.R., REVENUE ACT OF 1950, H.R. REP. NO. 81-2319, at 43-44 (1950).

204 Sullivan, *supra* note 8.

205 *Id.*

206 *Id.* Interestingly, some commentators see foundations as *overly* entwined with government. In the July 20, 2020 issue of *The New Yorker*, Jane Mayer details the ways in which foundations created and funded by Robert Cameron, the owner of Montaire Corporation, one of the largest poultry purveyors in the United States, have helped Cameron exert political influence. Jane Mayer, *How Trump is Helping Tycoons Exploit the Pandemic*, NEW YORKER (July 13, 2020), https://www.newyorker.com/magazine/2020/07/20/how-trump-is-helping-tycoons-exploit-the-pandemic [https://perma.cc/FQ2T-E5WG] ("[T]his decline in worker power, more than any other structural change in the economy, accounts for nearly all the gains in the share of income made by America's wealthiest one per cent. An outgrowth of this trend is the accumulation of enormous wealth and political influence by private foundations.").

fit of the funds they subsidized flowing to charities on the ground," the Institute for Policy Studies proposed doubling the annual payment requirement for private foundations to 10% and instituting a 10% annual payment requirement for DAFs, with these reforms to continue for the next three years.[207] Pointedly, the Institute for Policy Studies noted, "[F]or every $1 a billionaire gives to charity, the rest of us chip in as much as 74 cents in lost tax revenue."[208] An Ipsos poll suggests that 72% of Americans would support this change.[209]

The reactions mirror the unease about concentration of wealth that predominated in the Gilded Age and the concerns voiced in the Congressional testimony leading up to the Act's passage that foundations exercised undue control over civic life. Nicolas Berggruen, a "billionaire philanthropist," according to *The New York Times*, connected the backlash to the Notre Dame reconstruction efforts with both of these: "In the age of anxiety," he told *The Times*, "people will look to accuse lots of different groups for all of the evil or some of the evil. Rich people for sure fall into this. Philanthropists are an extension of that."[210] Phil Buchanan, Chief Executive Officer of the Center for Effective Philanthropy, explicitly attributed criticism of philanthropists to "anger over unequal distribution of wealth," and defended private philanthropists by contending, "I don't believe most big philanthropists are motivated by a desire to maintain the status quo via their giving or to protect themselves from higher taxation."[211] He noted the important social contributions of many private foundations: the Robert Wood Johnson Foundation, for example, supported the "911 emergency system and the field of nurse practitioners," and the Libra Foundation, funded by a branch of the Pritzker family, "supplied $350,000 in grants to organiza-

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207 *See* Chuck Collins & Helen Flannery, *The Case for an Emergency Charity Stimulus: An IPS Inequality Briefing Paper*, Inst. for Pol'y Stud. 5-6 (May 11, 2020), https://inequality.org/wp-content/uploads/2020/05/Brief-CharityStimulus-Revision-May12-FINAL.pdf.

208 *Id.* at 13.

209 *Americans' Understanding and Opinions about Charitable Foundations and Donor-Advised Funds*, Inst. for Pol'y Stud. 6 (May 30, 2020), https://inequality.org/wp-content/uploads/2020/06/Summary-of-American-Opinions-re-Foundations_May-30-2020.pdf. In fact, there appears to be support for increased foundation payouts from within the foundation sector as well. The current presidents of several foundations (including the Ford Foundation, the Kellogg Foundation, and the MacArthur Foundation) have pledged to significantly increase their payouts in light of COVID-19. David Brancaccio & Rose Conlon, *How the President of the Ford Foundation Would Reimagine the Economy*, Marketplace (July 2, 2020), https://www.marketplace.org/2020/07/02/ford-foundation-darren-walker-charitable-organizations-philanthropy-economy-social-bonds/ [https://perma.cc/5HFS-KUP2].

210 Sullivan, *supra* note 8.

211 *Id.*

tions addressing the needs of families being separated at the United States-Mexico border."[212] Regardless of private foundations' manifest social contributions, however, the public evidently remains skeptical of their value, stemming at least in part from concern over whether members of society should be as wealthy as many of the well-known founders of private foundations are, and whether those causes that receive substantial financial assistance should be determined largely by private citizens.

Public skepticism extends to the Act, not only because of broader undercurrents of anxiety about wealth and private foundations' control over charitable priorities, but also because of the rules themselves. Madoff points out, "There's no reason that private foundations should be defending meeting the 5% test by employing your kids and taking trips to Hawaii,"[213] a reference to the fact that salaries and travel expenses paid to family members are excluded from the self-dealing prohibitions and count toward a foundation's minimum distribution requirement. It's "kind of crazy that they excluded that," she notes; "It's a double whammy — both that it's not self-dealing to employ your children and that it satisfies the 5% [minimum distribution] rule."[214] Sare points to the fact that a foundation may satisfy its minimum distribution requirement by making large distributions to donor-advised funds, or DAFs, discussed in greater detail in the following section,[215] as creating a belief among some sector critics that charitable funds are being stockpiled through DAFs, because there is no guarantee that the recipient DAF will, in turn, distribute those funds out to other public charities in a timely manner.[216] Ewenstein points to the example of a donor to a U.S. charity that intends to re-grant the donated funds to a foreign charity, noting the requirement that "you can have no oral or written agreement as to what the 'middleman' is doing."[217] She wonders what the distinction between a conversation and an oral agreement really is.[218] The rules themselves, then, contain the seeds of their own undoing.

212 *Id.*

213 Madoff Interview, *supra* note 154.

214 *Id.*

215 *See infra* Part III.B.5.

216 Sare Interview, *supra* note 94.

217 Ewenstein Interview, *supra* note 156. A domestic foundation may make a grant to a domestic public charity with the tacit understanding that the public charity will ultimately use the grant to support a foreign charity. That arrangement frees the foundation from having to exercise expenditure responsibility while still effectively supporting a foreign charity, as long as no express agreement has been reached with the intermediary domestic public charity.

218 *Id.*

New rules enacted since the Act's passage have had the further effect of undermining public confidence in the regulatory regime. Congress enacted the so-called Newman's Own exception to the excess business holdings rule in 2017.[219] It permits a private foundation to own 100% of the voting stock in an operating business if (a) the foundation did not purchase those interests, (b) all of the business's net operating income is distributed to the private foundation, and (c) the business is operated independently from the private foundation.[220] To Manny, this exception represents a "whittling away" of the prohibition on excess business holdings.[221] Sare adds: "Some would say it allows one of the things the 1969 Act was meant to avoid, in that it enables a private foundation to have a really concentrated position in a single company, which often may not be desirable from a fiduciary standpoint."[222] If Congress is essentially legislating against the aims of the 1969 Act, how can the public be expected to remain convinced that the Act's requirements are necessary or wise?

And finally, highly publicized examples of foundations that continue to misbehave further undermine public confidence in the governance regime imposed by the Act. In one of the highest-profile examples of such misbehavior, in 2018, Barbara Underwood, then the Attorney-General of New York State, initiated an investigation into the Donald J. Trump Foundation and ultimately accused the Trump Foundation of violating many of the Act's rules.[223] According to the complaint filed in New York State Supreme Court in June 2018, the Trump Foundation provided administrative assistance at a political fundraiser in Iowa,[224] received funds from that fundraiser, and disbursed the funds in accordance with campaign staff directives,[225] and separately used funds to make donations to the Florida Attorney-General's reelection campaign in 2013,[226] all in violation of the prohibition on foundation engagement

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219 *See* Jeff Getty, *Newman's Own Tax Relief Available to Others*, 20 J. Allegheny Cnty. Bar Ass'n, Nov. 23, 2018 at 10, 10. This rule is known as the Newman's Own exception because it effectively permitted the Newman's Own Foundation to continue to hold interests in the company that operates Newman's Own beyond the five-year period following Paul Newman's death. The Newman's Own Foundation would otherwise, in accordance with the excess business holdings rule, have been required to divest itself of 80% of the interests in the company five years after having inherited those interests from Paul Newman's estate. *See supra* Part II.D.

220 I.R.C. § 4943(g).

221 Manny Interview, *supra* note 148.

222 Sare Interview, *supra* note 94.

223 *See* Verified Petition at 1, New York v. Trump, 88 N.Y.S.3d 830 (N.Y. Sup. Ct. June 14, 2018) (No. 451130/2018).

224 *Id.* at 11.

225 *Id.* at 13-14.

226 *Id.* at 21-22.

in political activities. The complaint is littered with examples of violations of the self-dealing rules, too, including the use of foundation funds to settle Donald Trump's personal, resort-, and hotel-related lawsuits[227] and the foundation's purchase of a $10,000 portrait of Mr. Trump to be displayed at a property he owned.[228] Underwood characterized the Trump Foundation as "functioning as little more than a checkbook to serve Mr. Trump's business and political interests," and labeled its operations "a shocking pattern of illegality."[229] A judge ordered Mr. Trump to pay $2 million in damages to nonprofit groups after he admitted fault for these acts of mismanagement.[230] But the misdeeds of the Trump Foundation stretched back many years; if they were so "shocking," why had no one bothered to investigate formally before Mr. Trump became President? The public cannot be expected to have confidence in a regulatory regime that is not enforced.

5. *The Rise of Alternatives*

Unsurprisingly, as a result of the Act's undue complexity, lack of dialogue with the IRS, bright-line rules penalizing conduct that may in fact aid charitable causes, and the lack of public faith in the private foundation regulatory regime, private philanthropists have increasingly turned to alternatives. As those alternatives proliferate, it is worth asking why private foundations should continue to be subject to these complex rules if the rules can simply be avoided, with a price — the inability to implement a philanthropic vision through piloting specific programs, or to claim certain tax deductions — that philanthropists are increasingly willing to pay.

A common alternative to private foundations is a donor-advised fund, commonly known as a DAF. A DAF is a giving vehicle held at a public charity or a large financial institution, such as Fidelity or Schwab, that itself counts as a public charity for tax purposes.[231] A donor may contribute funds to a DAF while retaining advisory powers over grant amounts and recipients.[232] This structure mirrors the ability of the governing board of a private foundation to determine grant recipients, but does not require a donor to comply with the Act's governance restric-

227 *Id.* at 24-25.
228 *Id.* at 30.
229 Shane Goldmacher, *Trump Foundation Will Dissolve, Accused of 'Shocking Pattern of Illegality*,' N.Y. TIMES (Dec. 18, 2018), https://www.nytimes.com/2018/12/18/nyregion/ny-ag-underwood-trump-foundation.html [https://perma.cc/X48C-JW3P].
230 Alan Feuer, *Trump Ordered to Pay $2 Million to Charities for Misuse of Foundations*, N.Y. TIMES (Nov. 7, 2019), https://www.nytimes.com/2019/11/07/nyregion/trump-charities-new-york.html?module=inline [https://perma.cc/2Z4P-LNNP].
231 Cullman & Madoff, *supra* note 14.
232 *See id.*

tions or maintain any administrative infrastructure. "People keep looking for simplicity," Fox noted, which, to him, explains the rise and popularity of the DAF.[233] "DAFs have changed everything," Manny adds. "They provide a way to get around a lot of the rules" and are "a great equalizer" because "[y]ou don't have to be Bill Gates to set up your own fund" but can still accomplish many of the goals of a private foundation, "unless," she notes, "you want to hire your children."[234] Madoff concurs: "It's a little bit like 'other than that, Mrs. Lincoln,'" because DAFs "have so dwarfed other charitable giving. Every year they're now five and six of the top ten charitable organizations in terms of donations."[235] While, as Sare points out, DAFs predate the 1969 Act,[236] and so their rise cannot be solely attributed to philanthropists' desire to avoid the Act's cumbersome restrictions, DAFs have certainly come to the fore in recent years.

But the rise of DAFs may ultimately be problematic for the landscape of charitable giving. Despite the fact that the DAF structure may reduce barriers to entry for philanthropists, DAFs have no minimum distribution requirement. A donor will receive an immediate tax benefit for funds contributed to a DAF without any assurance of near-term corresponding social benefit.[237] As Madoff and philanthropist Lewis B. Cullman write, contributions to DAFs, which "have been given the tax benefits of charitable donations," may "be held in a DAF for decades or even centuries, all the while earning management fees for the financial institutions managing the funds, and producing no social value."[238] Indeed, according to Cullman and Madoff, "nearly 22 percent of all DAF sponsors reported *no grants at all*."[239] Furthermore, while many foundations have piloted important social programs that are targeted to meet specific needs that the government cannot or will not address — the Robert Wood Johnson Foundation's sponsorship of the 911 emergency

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233 Fox Interview, *supra* note 155.

234 Manny Interview, *supra* note 148.

235 Madoff Interview, *supra* note 154.

236 Sare Interview, *supra* note 94. Sare notes that the original DAFs were housed at community foundations, and that it has only been in more recent decades that DAFs associated with large investment firms have come into existence. *Id.*

237 *See* Cullman & Madoff, *supra* note 14.

238 *Id.* ("Because of a 1991 IRS ruling obtained by Fidelity (and similar rulings obtained by other commercially sponsored DAFs), clients get the same tax benefits when they transfer property to their donor-advised funds that they would get by making outright contributions to a museum, soup kitchen, university, or any other federally recognized charity. But no deadline is imposed for the eventual distribution of these funds to an operating charity.").

239 *Id.*; *see also supra* text accompanying notes 207-09 (discussing the Institute for Policy Studies's proposal to impose a minimum payout requirement for DAFs).

dial system,[240] the Sarah Scaife Foundation's polio-related grants,[241] and the Carnegie Corporation's support of public libraries across the country,[242] among the many examples identified in this article — those programs are unlikely to be fostered via contributions to a DAF for several reasons. First, distributions from DAFs are typically made anonymously,[243] which makes it unlikely that a DAF's donor-advisor would be a visionary philanthropist eager to endow and support an ongoing program, either because the donor-advisor is not interested in so being or because the donor-advisor is not *sufficiently* interested to merit the start-up costs and ongoing compliance requirements of a private foundation. Second, the structure of the DAF only permits the donor-advisor to advise on the amounts and recipients of distributions;[244] it does not permit a donor-advisor to establish and oversee a particular program, which discourages the contribution of funds to smaller charities over which the donor-advisor could have more significant influence and, potentially, a higher degree of control. Correspondingly, DAF distributions are more likely to be contributed to large existing charities that are already well-funded. And third, many DAFs are governed by financial advisory organizations, which, to earn management fees, often encourage donor-advisors to "hoard, rather than distribute, their DAF funds."[245]

Moreover, the DAF structure has served to further erode public confidence in the regulatory regime governing private philanthropy, both by concocting a legal fiction that a DAF's sponsoring organization would ever deny a donor-advisor's request and by raising the question of why private foundations need to be subject to the Act's myriad complexities while a different type of organization that accomplishes a similar goal need not be. Hall reflects, "I doubt there are many examples of sponsoring organizations turning down a grant request from a DAF ad-

240 *See supra* text accompanying note 212.

241 *See* Frumkin, *supra* note 5, at 266-67.

242 *See* Viadero, *supra* note 6.

243 Helaine Olen, *Is the New Way to Give a Better Way to Give?*, ATLANTIC (Dec. 13, 2017), https://www.theatlantic.com/business/archive/2017/12/donor-advised-funds-deduction-charity/548324/ [https://perma.cc/9MES-VLAQ] ("When money arrives from a donor-advised fund, a charity often doesn't know who actually made the donation.").

244 *See* I.R.C. § 4966(2)(A)(iii).

245 *See* Cullman & Madoff, *supra* note 14. Notably, however, this trend may not continue for the 2020 calendar year in light of the COVID-19 pandemic. *See, e.g.*, *Communities in Crisis: How Donors are Responding to COVID-19*, FIDELITY CHARITABLE (2020), https://www.fidelitycharitable.org/content/dam/fc-public/docs/insights/communities-in-crisis-how-donors-are-responding-to-covid-19.pdf. In the first four months of 2020, DAFs distributed $3.4 billion, an increase of 28% from the same period in 2019. *Id.*

visor to an entity listed in Publication 78.[246] It does make you wonder why we cannot accommodate in our tax system donor-directed funds and avoid what looks a lot like a control-charade."[247] But the requirements of this "charade" are far easier to comply with than the private foundation governance rules of the 1969 Act. Other than for the philanthropists who are most committed to implementing a vision for charitable work by creating and overseeing new programs, the ease of administration of a DAF will, for most, outweigh the potential benefits of the private foundation structure. This has the undesirable consequence of deterring philanthropists who might otherwise be actively engaged in beneficial charitable programs through their private foundations. The tax deduction is the same, so, for those philanthropists on the fence, is it really worth bothering with a private foundation?

Section 501(c)(4) organizations are another increasingly popular alternative. A 501(c)(4) organization is a so-called social welfare organization, which is required to promote the common good and general welfare of those in a particular community. A donor may not receive an income tax deduction for donations to a 501(c)(4) organization, but donations do qualify for a gift tax deduction, and permit a donor to defer or eliminate capital gains on donated assets. As David Miller points out, "the crucial assumption underlying the different treatment between section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations is that the charitable deduction is more valuable to taxpayers than the capital gains exclusion. For most taxpayers, this assumption is correct. For super-wealthy people, this assumption is not."[248] Dale agrees, noting that 501(c)(4) organizations are "growing like crazy" because "for most really wealthy taxpayers, the income tax deduction is close to valueless. The gift tax deduction really matters."[249] Sare concurs, noting, "It never really seems to have occurred to people in 1969 that there would be a significant population of people who have significant wealth who would be willing to forego the income tax charitable deduction," but, in fact, that is exactly the case now, which explains why "[t]he 501(c)(4) has become the vehicle of choice for a lot of

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246 Hall Interview, *supra* note 151. Publication 78 is the colloquial name for the IRS's so-called Cumulative List, which identifies organizations that have been designated by the IRS as eligible to receive tax-deductible contributions from donors. INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 25.7.6(1) (Jan. 1, 2018), https://www.irs.gov/irm/part25/irm_25-007-006 [https://perma.cc/8P9R-FQ95].

247 Hall Interview, *supra* note 151.

248 David S. Miller, *Social Welfare Organizations as Grantmakers*, 21 N.Y.U. J. LEGIS. & PUB. POL'Y 413, 435 (2018).

249 Dale Interview, *supra* note 68.

philanthropy."[250] The tax benefits of the 501(c)(4) organization, then, are a primary driver of its popularity.

The assets of a 501(c)(4) organization may inure in part to the benefit of its donor[251] — another reason for the 501(c)(4) organization's popularity. Miller explains that a 501(c)(4) organization "can benefit classes or a community that would not be charitable for purposes of section 501(c)(3) and can provide private benefits so long as providing private benefits is not the organization's primary activity."[252] He gives the example of a 501(c)(4) organization created with the purpose of beautifying a single city block. The organization would assuredly increase the property values of those who live on the block and so could not qualify as a public charity or private foundation because its private benefits would be substantial, but that mission would be permissible for a 501(c)(4) organization. Indeed, a 501(c)(4) organization's assets "need not be used exclusively for charitable purposes; instead, the assets may be used for more relaxed social welfare purposes . . . ."[253] A 501(c)(4) organization, then, can shelter capital gains *and* offer some private benefit.

Finally, the 501(c)(4) organization is administratively far less cumbersome than a private foundation. A 501(c)(4) organization is easy to set up: a donor need only file a Form 8976 with the IRS within 60 days of the organization's establishment. It is not subject to the minimum distribution requirement, may engage in political activities, and need not comply with the self-dealing rules; instead, it is only required to satisfy the "more relaxed 'excess benefit transaction' rules."[254] It need not exercise expenditure responsibility for grants made to individuals or foreign charities, and may hold interests in companies without regard to the excess business holdings rules. It is no wonder, then, that 501(c)(4) organizations have become popular.

But the increased use of 501(c)(4) organizations also has potentially detrimental social consequences. Donors receive capital gains tax exemptions for transferred assets without any assurance to the public of the type of wide-ranging social benefit that, ideally, private foundations (and public charities) would engender because 501(c)(4) organizations are not subject to the same limitations on charitable purposes. And if a significant reason why donors are flocking to 501(c)(4) organizations is, as commentators indicate, the ability to distribute funds for reasons other than religious, charitable, scientific, public safety-related, literary,

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250 Sare Interview, *supra* note 94.
251 *See* I.R.C. § 501(c)(4)(B).
252 Miller, *supra* note 248, at 418.
253 *Id.* at 416.
254 *Id.* at 416-17; *see supra* note 187.

or educational purposes, and to do so while sheltering assets from capital gains tax — two motivations unlikely to speak to truly visionary philanthropists — it is far less likely that a 501(c)(4) organization would be responsible for the type of valuable programs that private foundations have fostered. But were private foundations a more appealing option, those who might otherwise create 501(c)(4) organizations while being inclined toward more traditional philanthropic endeavors could still be encouraged to opt for private foundations instead: after all, there are certainly other mechanisms for reducing one's capital gains taxes that do not involve philanthropy, so those who establish 501(c)(4) organizations are likely to have at least some significant interest in charitable endeavors. Those would-be private foundations are missed opportunities for new socially-beneficial programs.

The DAF and the 501(c)(4) organization are both attractive options for private philanthropists seeking alternatives to private foundations. Their popularity is understandable. DAFs and 501(c)(4) organizations are both easy to establish. DAFs require donors to expend virtually nothing on their ongoing administration, and neither DAFs nor 501(c)(4) organizations are subject to the byzantine requirements of the private foundation regulatory regime. Both present significant tax advantages to donors, and a 501(c)(4) organization's assets may even benefit, in part, the donor himself or herself. But, for the reasons discussed above, the structures of both of these alternatives make it far less likely that they will achieve the societal accomplishments of foundations past. Were private foundations a less cumbersome option, it is likely that at least some philanthropists who currently use DAFs or 501(c)(4) organizations as giving vehicles might instead opt for private foundations, with the appurtenant prospect of greater social benefit.

IV. Proposed Solutions

Private foundations, as we have seen, have pioneered innovations and created social programs that have been manifestly beneficial. They are uniquely suited to nimbly target particular societal needs that are unmet by the government. For those reasons, it is this author's view that we ought to find ways to restore private foundations to their place of primacy, and to see the rise of alternatives as a warning bell that our window of opportunity may be closing.

A number of commentators began our interviews by sharing the view that we need a clean slate for foundation governance — that the rules are hopelessly complicated and penalize behavior that is not only not harmful but may in fact be beneficial for philanthropy. Commentators particularly focused on the self-dealing rules and, to a lesser extent, the excess business holdings rules.[255]

We can agree that donors should not abuse their relationships with private foundations for personal gain. The question is how to craft a regulatory regime that carries out that philosophy without unduly burdening foundations or prohibiting behavior that should be permitted. The arm's-length tests of the pre-1969 tax laws that applied in the self-dealing and excess business holdings contexts did prove unworkable, as we have seen; however, that unworkability was, at least in significant part, due to the insufficient strength, capacity, and resources of the IRS's audit function, and also to the IRS's general lack of sophistication at the time about the nature and activities of private foundations.[256] In the intervening half century since the Act's passage, the IRS has certainly become expert in these issues and acutely aware of the practices and activities of private foundations.

What has not changed, however, is that the IRS does not have the resources to engage in sufficient audits or meaningful dialogue with private foundations.[257] A more robust and well-resourced audit function would allow us to move away from the bright-line rules that have proven to be overbroad and exceedingly complex. In the self-dealing context, potential violations of foundation managers' fiduciary duties and fidelity to charitable endeavors should be evaluated on a case-by-case basis. As Hopkins noted, "The inability of the IRS to abate the self-dealing tax has always struck me as being a little overdone and somewhat unfair. Because, of course, intent in the self-dealing context is totally irrelevant" for the purposes of section 4941,[258] though arguably it should be a factor in imposition of penalties given the complexity of the section's requirements.

In the excess business holdings context, a three-tiered system should be implemented. The bottom tier would represent business holdings that are per se acceptable, with a higher threshold than the 20 (or 35) percent limitations currently in place.[259] The top tier would re-

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255 *See supra* Parts II.B (discussing the self-dealing rules) and II.D (discussing the excess business holdings rules).

256 Owens notes that "the first Form 990 was created in 1941, and before that there was just no flow of information at all about tax-exempt organizations," and it wasn't until the 1950s that "the IRS began a program of oversight" and created a division in the national office of the IRS to oversee these organizations. Owens Interview, *supra* note 67.

257 Paul Kiel & Jesse Eisinger, *How the IRS Was Gutted,* ProPublica (Dec. 11, 2018, 5:00 AM), https://www.propublica.org/article/how-the-irs-was-gutted [https://perma.cc/Q4YY-2FSN].

258 Hopkins Interview, *supra* note 140.

259 *See supra* Part II.D (discussing the excess business holdings rules).

present business holdings that are per se unacceptable. And the middle tier, between the percentage limitations of the bottom and top tiers, would represent business holdings at intermediate levels, the propriety of which would be evaluated on a case-by-case basis. The Treasury Department should make a recommendation to Congress as to the percentages applicable to each category by evaluating the operations of foundations that report either having to divest themselves of excess business holdings (and considering whether such divestments represented beneficial outcomes for the foundations at issue and charitable causes more broadly) or holding concentrations of business interests near the upper limit of the currently-permissible thresholds (and considering whether those foundations' charitable goals were at all jeopardized by their business holdings).

These proposals would require that foundations report all potential self-dealing transactions and any business holdings with concentrations in the percentage range of the middle tier so that the IRS could properly evaluate them. This reporting regime has analogues in other areas of the law. For instance, the section 16 reporting requirements under the Securities Exchange Act of 1934 mandate that insiders of a company report transactions in which they engage that involve the company's securities by filing a Form 4 with the Securities and Exchange Commission.[260] This procedure has worked properly in the securities law context; there is no reason to think that it would not in the private foundations context.

The United Kingdom presents a useful example of how the IRS might enforce a fact-specific regime and, in so doing, engage in dialogue with foundations rather than simply act as a punitive force. As Clarissa Lyons, Senior Associate at Bates Wells Braithwaite LLP in London with a practice focused on charity and charity legacy planning, explained, when the Charity Commission, which regulates U.K. charities, discovers or is tipped off to breaches of trust, it "will generally engage the charity in the first instance" rather than simply levying a penalty from the outset.[261] "The powers that they have," Lyons continued, include "a sort of warning power, where they will warn a charity's trustees that their activities are not acceptable and they may need to take certain action."[262] That warning is usually made public.[263] The Charity Commission also has "the power to, in more extreme cases, remove certain trustees who

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[260] U.S. Sec. & Exch. Comm'n, SEC1475 (05-19), Form 4: General Instructions 1, 2 (2019), https://www.sec.gov/files/form4data%2C0.pdf.

[261] Interview with Clarissa Lyons, Senior Assoc., Bates Wells Braithwaite LLP (June 17, 2019).

[262] *Id.*

[263] *Id.*

have been shown to be acting improperly," and "put interim managers in place of those trustees."[264]

How does the Charity Commission evaluate whether a particular act is worthy of sanction? "You would look to see if the principles of trust law have been managed properly," Lyons explains. In the case of a transaction that could potentially raise self-dealing issues, the Charity Commission evaluates the process by which the transaction was consummated, looking to see if any resulting benefit was permitted by statute or by the charity's governing documents and that "[t]he relevant person didn't take part in the decision-making process and the other people involved decided it was in the best interest of the charity."[265] But, as Lyons notes, there are "no bright-line rules, so charity trustees must adhere to their fiduciary duties."[266] Recently, the Charity Commission has had difficulty enforcing these standards due in significant part to the fact that the Charity Commission "has seen big budget cuts in recent years which have affected its staffing levels."[267]

To properly enforce a fact-specific regulatory regime, then, the audit and engagement function must be well-funded. Fortunately, the 1969 Act's legislative history provides the solution: use the "audit fee" — which is how legislators understood the tax on net investment income — for its intended purpose.[268] Absent this use of the net investment income tax, it is difficult to justify the tax at all. The excise taxes that arise for violations of the self-dealing and excess business holdings rules, for instance, are intended to shape behavior by penalizing foundations for engaging in activities that Congress has decided are impermissible. But why should private foundations — tax-exempt entities — be taxed on their net investment income, the accumulation of which is not only permissible but *desirable*? Manny notes that "Oversight is good for the sector. But the money [from the net investment income tax] . . . just goes right into the federal coffers and they use it for whatever they want to

264 *Id.*

265 *Id.*

266 *Id.*

267 *Id.* One recent development suggests rumblings of a revitalization of the Charity Commission. In July 2020, the U.K. announced that it would be funding one of the Commission's programs designed to reallocate money from dormant trusts into charities, a program that the Commission notes has transferred £32 million since 2018. *See* Press Release, *Charities Receive over £32 Million from Dormant Trusts*, CHARITY COMM'N (July 3, 2020), https://www.gov.uk/government/news/charities-receive-over-32-million-from-dormant-trusts [https://perma.cc/22KV-S8L2].

268 S. REP. NO. 95-790, at 1 (1978).

use it for. It's not serving its original intended purpose."[269] For that reason, Fox calls this tax "just crazy."[270]

According to IRS data, $581 million was collected in net investment income tax in 2016.[271] In fiscal year 2016, the IRS appropriated approximately $4.9 billion to enforcement across *all* areas, of which private foundation governance is a very small part.[272] If even a fraction of the funds generated by the net investment income tax were actually used as intended for audit purposes, we would be able to fund a robust enforcement and oversight body that could engage in dialogue with the regulated entities.

A cascade of benefits would flow from allocating these funds as Congress intended, making it the single most important fix that Congress can implement. Congress could then remove the bright-line rules in the self-dealing context and limit their applicability in the excess business holdings context, and permit foundations to engage in certain behavior that is now penalized but would ultimately be beneficial to charitable causes. Removing those bright-line rules could actually increase foundations' assets under management, both by eliminating the inadvertent tripping-up that commentators cited as a consequence of the rules' complexity and that triggers excise taxes, and by permitting foundations to engage in a broader range of financially-beneficial transactions. Foundation managers could consult the IRS when considering engaging in certain transactions to get a sense of whether the transactions would be penalized. And the IRS could effectively promote *good* grant-making by serving as a real resource for private foundations, by issuing clarifying memoranda and rulings in the area, and by having the funding and staff to study the relative efficacy of various philanthropic dispositions, which likely would serve to buttress public faith in these organizations.

This funding could also allow the IRS to engage in projects that would lessen reporting burdens on foundations and make reported information more useful to foundations and the public. Ewenstein suggests, for instance, that the IRS compile a searchable database of Form 1023 applications[273] so that those philanthropists seeking to create pri-

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269 Manny Interview, *supra* note 148.

270 Fox Interview, *supra* note 155.

271 INTERNAL REVENUE SERV., TABLE 1, *supra* note 4.

272 *Program Summary by Appropriations Account and Budget Activity*, INTERNAL REVENUE SERV. (2017), https://www.irs.gov/pub/newsroom/IRS%20FY%202017%20BIB.pdf.

273 These are applications for charitable exemptions that private foundations file on inception. *See About Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*, INTERNAL REVENUE SERV., https://www.irs.gov/forms-pubs/about-form-1023 [https://perma.cc/Y833-JFZD].

vate foundations could have a sense of what the IRS has already approved when modeling their own foundations.[274] The IRS could streamline the Form 990-PF[275] to reduce administrative costs in its preparation and increase available useful knowledge on private foundations. Owens calls the 990-PF an "unwieldy document" and "a shield from disclosure. Some of the large private foundations' 990-PFs are a foot high of paper. It's difficult to find information."[276] Making the Form 990-PF more easily searchable could help mitigate that issue, as could the IRS's evaluating which information in the 990-PF the IRS, other foundation managers, and the public really need. The IRS appears to take a kitchen-sink approach to the 990-PF, without seeming to engage in any critical assessment of the *value* of new questions and disclosure requirements that it adds. The revenue from the net investment income tax could give the IRS the funding it needs to study and revise this annual report so that it can be useful to all parties.

To further incentivize good grant-making and remove unnecessary barriers to participation in private philanthropy, changes should be made to the minimum distribution requirement[277] and the expenditure responsibility rules.[278] With respect to the minimum distribution requirement, it is sound policy to require private foundations to pay out certain amounts for charitable purposes. After all, they are receiving tax exemptions — and donors are receiving income tax deductions — on the assumption that these entities will further charitable causes. Madoff proposes a tweak that would incentivize foundations to distribute more assets to charity: she suggests that foundations pay the 2% net investment income tax if they distribute up to 6% of their assets, a 1% tax if they distribute between 6% and 8% of their assets, and no net investment income tax if they distribute more than 8% of their assets.[279] That would, of course, reduce the "audit fee" pool of funds, so further study would be required to determine the likely outcome of pairing these new rules (perhaps at varying thresholds) with the required funding needs of the IRS's audit function. In addition, from a public confidence perspective, it may be desirable to remove foundations' ability to count certain expenses, like salaries and reimbursements, toward the minimum payout requirement.

Congress should also ease the burdens of the expenditure responsibility requirements, at least for foreign grantees. Given the obvious po-

274 Ewenstein Interview, *supra* note 156.
275 Smith, *supra* note 198, at 373 (discussing form 990-PF).
276 Owens Interview, *supra* note 67.
277 *See supra* Part II.C.
278 *See supra* text accompanying note 136.
279 Madoff Interview, *supra* note 154.

tential for abuse, it is logical to retain the expenditure responsibility requirements in the context of grants to individuals (though, as Manny points out, there are "so many ways around the rules about scholarships").[280] With respect to foreign grantees, however, Ewenstein suggests a workable solution: the IRS could provide guidance that, with regard to foreign non-profit organizations that have particular known charitable designations in their home countries, those charities should be designated as U.S.-equivalent public charities or private foundations (which the IRS already does with respect to certain Canadian tax-exempt organizations under an existing tax treaty with Canada)[281] so that grants to such organizations would be subject to the same rules that would apply with respect to grants to domestic organizations.[282] Given that domestic societal needs often blur with international ones — the current COVID-19 pandemic and the Ebola outbreak of 2014 are only two such recent examples — it makes sense to permit foundations to expand their global reach.

V. Conclusion

Based solely on IRS data, private foundations appear to be thriving. But a closer look reveals that foundation alternatives — in particular, DAFs and section 501(c)(4) social welfare organizations — are rising to prominence in part because of widespread discontent with the private foundation regulatory regime enacted as part of the 1969 Tax Reform Act. And structural attributes of these foundation alternatives threaten to reduce the efficacy of private philanthropy, with potentially alarming consequences. Accordingly, while well-intentioned, the restrictions enacted as part of the 1969 Act have ultimately contributed to the erosion of public confidence in private foundations and to the dismantling of the very system of private philanthropy that Congress — rightly — sought to shore up in its legislation.

Fortunately, fixes are available. The revenue from the net investment income tax can be applied to the IRS's audit and enforcement program, which would allow Congress to replace the overly broad bright-line rules incorporated into the Act with fact-specific tests and facilitate good grant-making by promoting dialogue between the IRS and foundation managers. Greater funding could reduce the burdensome requirements of the current Form 990-PF and make disclosed information more usable for regulators and practitioners alike. Tweaks to the minimum distribution requirements and expenditure responsibility

280 Manny Interview, *supra* note 148.
281 Ewenstein Interview, *supra* note 156.
282 *Id.*

rules could buttress public confidence in the regulatory regime and promote less conventional — and perhaps more impactful — grant-making. Together, these changes would make private foundations a more appealing choice for philanthropists and improve the landscape of charitable giving.

While the American public and Congress have been, paradoxically, supportive and suspicious of private philanthropy since the country's inception, the social benefit of many private foundations' programs and grants is manifest. Congress has the opportunity to retool the private foundation regulatory regime to ensure that private foundations maintain their place of primacy in private philanthropy and continue to deliver these socially-beneficial results. But with alternatives proliferating rapidly, its window of opportunity may be closing. It is time for Congress to step in again so that the private foundation — and the important charitable benefits it can provide — does not become an artifact of the past.