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The regulation of American foundations: looking backward at the Tax Reform Act of 1969[*]

Abstract

The American Tax Reform Act of 1969 represented a major watershed in the law of philanthropy, introducing a new classification scheme — one that sharply distinguished between 'private foundations' and other charitable organisations — and, for the private foundation category, a new regulatory system, new regulatory sanctions, a new tax on investment income and new restricitons on the deductibility of property gifts. After briefly tracing the origins of this legislation, the paper sets forth five norms that should characterise the legislative process, and proceeds to explore, albeit in abbreviated fashion, the extent to which each of these norms was respected by the Congress in 1969. The paper then turns from an examination of regulatory principles to a consideration of regulatory *impacts*, dealing with several ways in which the 1969 Act appears to have caused diversion of resources, including: diversion of charitable giving from foundations to non-foundation charities (with consequences for the 'birthrate' of foundations); diversion of resources from charitable to non-charitable uses; diversion of funds from charitable channels to the US Treasury; and a diversion of resources from certain grantees to others. The mitigating effects of recent forms of *de*regulation are described, followed by the suggestion that more deregulation is desirable, in order to sustain the health and strength of America's private foundation sector.

Among the great legal watersheds of American philanthropy — the English Statute of Charitable Uses of 1601, defining charitable purposes,[1] or the 1917 tax legislation introducing the charitable contribution deduction (discussed in Fishman and Schwarz, 1995, pp.825-6) — the Tax Reform Act of 1969[2] deserves a prominent place. It introduced a new classification scheme into the law, dividing the charitable

universe into 'private foundations' (with certain subspecies) and organisations that are *not* private foundations (the latter group popularly known among lawyers as 'public charities'). Then, focusing on the new private foundation category and departing dramatically from the prevailing Anglo-American law of charity, the 1969 Act:

- imposed an income tax (albeit a modest one) on the investment income of these charitable groups;
- created a detailed regulatory code of conduct for such organisations;
- imposed penalty taxes on organisations that violate the regulatory code (as compared to the traditional tax sanction, loss of exemption); and
- restricted the ability of donors to deduct the full value of property gifts to these charities.[3]

A quarter century has passed since this tranformative legislation, and it is appropriate at this time to cast a retrospective gaze at what was wrought in 1969. The starting point for this *tour d'horizon* is the climate in which Congress acted. Thoughts of 1969 conjure up Vietnam and the protests and the youth rebellion, but that period of time also witnessed a less dramatic state of siege: the assault against America's private foundations. The attacks throughout the 1960s came from all sides. They came from the right, echoing a Congressional committee's 1953 indictment of the foundations as seed-beds of subversion, globalism and other -isms, including 'social-science-ism'. And attacks came from the populist left: from Congressman Wright Patman of Texas, accusing the big foundations of elitist grant-making and a cartel-like grab for power over the American economy, and from Senator Albert Gore Sr of Tennessee, who likened the power of 'unaccountable' foundations to that of the sixteenth century English churches (Simon, 1965; Nielsen, 1977).

The siege came also from teacher organisations, angry at the Ford Foundation's school decentralisation efforts, and from members of Congress offended by certain episodes: the use of foundation money by Frederick Richmond to try to unseat the powerful Congressman John Rooney, as well as the Ford Foundation grants that gave unusual rehabilitative help to the aides of the murdered Robert Kennedy (Nielsen, 1977). Other attacks had origins in racial conflict: an unreconstructed George Wallace complained about those 'pointy-headed' foundation people in New York 'looking down on' the people of the South, and apparently some were Southerners upset about foundation voter registration activity. Even academics were offended: Jacques Barzun complained that foundations 'weakened the intellectual and perhaps the moral fiber of men and institutions' (Simon, 1965, p.144).

Sharply distinguished from these political and ideological foes, the Treasury Department weighed in, issuing a 1965 report that paid tribute to the social value of foundations but voiced a litany of complaints about fiscal and fiduciary abuses — self-dealing (financial transactions between a foundation and the insiders who control the foundation), insufficient yield and pay-out, shoddy or corrupt investment practices, ownership of controlling corporate interests, as well as objections to donor control of foundations (US Treasury Department, 1965). The Treasury presented no data indicating that the fiscal-fiduciary abuses infected more than a small percentage of foundations, but it gave colourful and dramatic examples to buttress its case.

Add to all this two sources of foundation vulnerability. First, the fact that foundations, more than other American institutions, were and are identified as pockets of great personal wealth. Here riches lie and, what is worse, here they are gratuitously dispensed. Second, an absence of conventional constituencies — no voters or customers, no alumni, students, parishioners, patients — that makes the foundations unique among American institutions for their freedom of action but, at the same time, uniquely susceptible to attack. Even the donees are difficult to mobilise in support of their patrons, since dependency generates attitudes much more complicated than simple gratitude. (The late Robert Hutchins, while a foundation officer, once lamented, 'Why do they hate us? We didn't even give them a grant!'[4])

Confronted with this sea of troubles, the wonder is that the foundations did not receive a *worse* buffeting in 1969 — one that might have had a more direct impact on their grant-making autonomy, or on their programmatic freedom of action, or on their longevity. There *were* some close calls. Senator Gore Sr's proposal to liquidate all foundations at age 40 won acceptance in the Senate Finance Committee and had to be beaten back on the Senate floor (Nielsen, 1977). A Finance Committee decision to ban all foundation support of voter registration activity had to be reversed at the eleventh hour. This proposed ban was a backlash reaction to a purist assault on a compromise provision a number of persons had worked out at great length with Treasury and Congressional staff members.[5] Earlier in 1969 the House Ways and Means Committee was talked out of a tentative proposal to prohibit all foundations from 'directly or indirectly engag[ing] in any activities ... intended ... to influence the decision of any governmental body' (Committee on Ways and Means, 1969, p.4). And the House's 7.5 per cent tax on foundation investment income was cut back to 4 per cent in conference.

In addition to these rescues, there were other, positive benefits from the legislation. The 1969 Act obviously deterred some unmeasurable

amount of fiscal or fiduciary misconduct. And the Act did help to reassure the citizenry about the integrity of the foundation world — even though there is room for doubt that the public at large knew or cared very much about foundations or their probity. Moreover, the 1969 Act did give Congressional blessing to 'program-related investing'[6] in its infancy, thus helping to encourage this important new instrument of modern philanthropy (Hill and Kirschten, 1994, pp.6.107-10).

Despite these benefits, the fact that Congress legislated in the midst of the state of siege did make a difference. The result, in my view, was a flawed approach to the regulatory issues the Congress faced. The foundation provisions of the 1969 Act failed to honour certain norms that characterise, or should characterise, the regulatory process. These values are set forth here, without analytical support, but in the hope that they have the ring of common sense and ordinary fairness:

- *Parsimony*. Regulation should be no heavier, nor cut more deeply, than is necessary. (Parsimony is not to be confused with simplicity, which appears to be unattainable in tax legislation.[7])
- *Flexibility*. Room should be allowed for regulators to deal with 'hard cases', so as to avoid outcomes that do not serve the underlying purposes of the legislation.
- *Federalism*. It should be recalled that outside Washington, DC there are 50 American sovereignties, all of which have a regulatory function — particularly in the field of fiduciary regulation — that has been the responsibility of the state courts of equity since long before there was an Internal Revenue Code.
- *Even-handedness*. Regulation should provide similar treatment for similarly-situated persons and groups.
- *Circumspection*. Literally, legislators should look about before acting — using peripheral vision to consider the side-effects of regulation.

Let us explore, albeit in rather abbreviated fashion, the extent to which these norms were respected by Congress in 1969.

First, *parsimony*. Parsimony was not honoured in the attempt to deal with the phenomenon of foundation control of business enterprises. Of the three Congressional objections to this pattern, the two that appeared to be plausible — inadequate yield to the foundation and unfair competition with non-foundation-controlled businesses — could effectively be handled by other provisions of the 1969 Act itself and (in case further assurance was needed) by other approaches suggested in 1969 testimony before the House and Senate Committees (Simon, 1969) and expanded in a 1983 Congressional presentation (Subcommittee on Oversight, 1983, Simon statement at pp.1626-47). Congress, however, engaged in the radical surgery of effectively prohibiting the acquisition

of what are called 'excess business holdings' (IRC §4943), with consequences which are discussed below.

Both *parsimony* and *flexibility* were given short shrift when Congress turned to the problem of self-dealing between a foundation and its donors or managers (IRC §4941). Parsimony would have called for a less strenuous legislative solution than Congress's absolute ban on self-dealing, prohibiting certain sale or lease transactions no matter how favourable to the foundation. Perhaps the courts, as the Treasury complained in 1965, had been too lenient in administering the existing provisions, but there were techniques — such as the use of presumptive rules — that could have toughened the judicial response. At the same time, a less rigorously prophylactic law would have permitted the Internal Revenue Service (IRS) and the courts to use more flexibility in dealing with honourable forms of self-dealing. For there *can* be honour in self-dealing. One does not like to take issue with the Sermon on the Mount (Matthew 6:24), but human experience tells us that it is indeed possible for a person to 'serve two masters', especially when it is done in the open.

Turning to the issue of *federalism*, it is evident that greater attention to this value would also have served the causes of parsimony and flexibility. State courts of equity and attorneys-general are more accustomed to dealing with the policing of fiduciaries than is the federal tax system. These state institutions have a wide range of remedial tools that are parsimonious and flexible — surcharge (a form of damages remedy), injunction, the issuance of instructions, removal of trustees, denial of trustee fees — as compared to the tax code's reliance on penalty taxes and loss of exemption. Most of the 1969 Congressional targets — self-dealing, business ownership, possibly the problem of low foundation pay-outs, and certainly speculative investments — involve fiduciary issues that are the meat and drink of state regulators. During a public debate with Treasury officials in about 1966, I recommended that the Federal Government take steps to help state attorneys-general do their job more efficiently and, thereafter, turn over the primary regulatory role to the states. This proposition was met with scorn: it could not be serious. But it *was* serious. It was, in part, based on a belief that a fair regard for principles of federalism should make us wary of relying on the national tax system to perform tasks that might, with help, be handled by state authorities. It would be difficult to argue that there is a need for nationally uniform treatment of foundation fiduciaries that is urgent enough to overcome such federalist scruples.

The Federal Government's exercise of power in this fiduciary-fiscal area becomes even more problematic when one considers the Congressional *remedy* adopted in 1969: not merely denial of tax-exempt

status but the imposition of several tiers of penalty-type excise taxes on foundations and their managers. That is a more efficient remedy than loss of exemption, but, at the same time, it represents an assertion of full-fledged regulatory power over America's foundations. What is the rationale for this federal role? The commerce power? Some other source?[8] The legislative history does not provide the answer. Even without a clear rationale, tax provisions are rarely, if ever, vulnerable to Constitutional attack. From a policy point of view, however, rather than a litigative perspective, it would be helpful to know what the rationale is and how solid it is.

While excise taxes cannot *ordinarily* be challenged on Constitutional grounds, one aspect of the 1969 Act represents an *extraordinary* use of the excise tax: to punish foundations for lobbying (IRC §4945(d)(I)). Note that even *in*substantial lobbying is prohibited, whereas other charities have more freedom to participate in the legislative process.[9] Thomas Troyer (1973) has written a fine analysis of the First Amendment implications of this particular penalty tax, implications which are far from trivial. On the whole, however, these federalism cavils may be quixotic. The American legal order is used to relying on the tax code to regulate the charitable sector.

Moving on to *even-handedness*, one example of discrimination between foundations and other charities — the lobbying rules — has just been mentioned. This disparity in treatment characterises all of the foundation sections of the 1969 Act. Some forms of discrimination, of course, have an empirical basis. But, as Boris Bittker (1973) has written, there was no showing that the vices attributed to foundations could not be found elsewhere in the non-profit sector. Indeed, Congress did not *look* elsewhere. The reason, in large part, was the state of siege, the political vulnerability mentioned earlier, and a rather surprising readiness of foundations to accept federal controls.

This paper should not be misunderstood as suggesting that the remedy for disparity is to impose the 1969 Act rules, warts and all, on the several million other American non-profit organisations or even on the several hundred thousand that have 501(c)(3) status. The point is simply that principles of even-handedness are an appropriate source of concern about the way Congress proceeded in 1969.

Before leaving the topic of even-handedness, we should note two examples of disparity in the 1969 Act that were not *regulatory* in nature. One was the 4 per cent tax (now a 1-2 per cent tax) on investment income — characterised, after some hesitation, as an 'audit fee' — imposed only on foundations (IRC §4940). The second was the provision that precludes deduction of the full market value of appreciated property given to a foundation for endowment purposes, while allowing a full deduction when the *same* property is given to

a public charity (IRC §170(e)). Not a word of explanation for the latter provision was provided by either the House or Senate Committee.

Now, finally, the norm of *circumspection*: the consideration of regulatory side-effects. In addressing the major side-effects, we shift from the regulatory *principles* we have been discussing to *impacts*. Each of these impacts represents, in one way or another, a diversion of resources. Several kinds of diversion appear to have resulted from the 1969 Act.

First, charitable gifts were significantly diverted from foundations to public charities. One major cause of such diversion was the combined operation of two discriminatory features mentioned above: the 'excess business holdings' rule, relating to foundation ownership of corporate control stock, and the appreciated property deduction rule.

As of the time of the 1969 Act, approximately 80 per cent of foundations with more than $10 million in assets had been endowed with corporate control stock or appreciated property or both. A study conducted by the Council on Foundations and the Yale Program on Nonprofit Organizations (Odendahl, 1987) revealed that, of all foundations with more than $100 million in assets as of 1982, 50 per cent had been formed with gifts of shares of non-publicly-owned companies, and 34 per cent had been started with gifts of shares of stock that represented voting control of the companies involved. Either type of gift would be likely to fall foul of the 'excess business holdings' rule, if made after October 1969, and of the appreciated property rule as well.

These data are suggestive of the impact of rules prohibiting or heavily discouraging the contribution to foundations — but not to other charities — of corporate control stock and appreciated property. The impact is hard to quantify, but the Yale-Foundation Council interviewers received convincing testimony about it during the course of interviews with 135 wealthy donors or potential donors and with 100 lawyers and other advisers. The interviewers were told that the 1969 Act provisions did indeed induce donors to pass these forms of wealth to other, more eligible receivers. (One lawyer reported that in a single year he created three churches and two schools — or vice versa — just to receive what would otherwise — in the hands of a foundation — be 'excess business holdings'.[10]) Because of these two statutory provisions and other complex rules thought to be minefields, and also because of the general nuisance of complying with the 1969 Act, those interviewed in the Yale-Foundation Council study often used alternative vehicles for charitable giving — not only schools and churches but community foundations and other 'public charities'. The irony is that these public charities are *far* less fully regulated than foundations under the tax code — and, in the case of churches, are not even

required to file information returns (IRC §6033(a)(2)(A)(i)).

Turning to the second form of diversion, it seems inevitable that some resources were diverted away from charity altogether, although statistical proof is not available. Discouraged by the disincentives militating against foundation creation, some potential donors, we must assume, decided not to go ahead with major charitable gifts, especially where estate planning techniques permitted them to achieve tax reduction goals without the use of a charitable disposition. The result in many cases would have been more resources for the children of these erstwhile donors. In other cases, the assets presumably were diverted not to the children but to other forms of non-charitable ownership — a chain buyer or a conglomerate buyer to which the foundation was induced to sell because it had to divest its 'excess business holdings' (Subcommittee on Oversight, 1983).

A third diversion has been caused by the tax on foundation investment income. Even though reduced in 1978 and 1984, this tax has diverted charitable dollars to the US Treasury in far greater amounts than any audit costs (Hill and Kirschten, 1994, p.6-6, note 12).

Fourth, for a considerable time there was a diversion of foundation investment assets from high-yield debt instruments to low-dividend equities, not because investment managers necessarily preferred such a shift, but because it was the only way to avoid the corpus-shrinking impact of the 1969 Act requirement that all net investment income be paid out. This provision was repealed in 1981 (Hill and Kirschten, 1994, p.6-62, note 318).

Fifth, some of the 1969 Act rules appear to cause resource diversion *among* grantees. Thus, foundations have an incentive to shift grant-making away from individuals to organisations, because grants to individuals are procedurally restricted by the Act (IRC §§4945(d)(3), 4945(g)). Moreover, foundations have an incentive to divert grants away from those organisations that do not qualify as 'public charities' to those that do, such as schools, churches, hospitals or groups that can meet 'public support' tests. The *non*-'public charities', assuming they do not make many grants, are categorised as private 'operating' foundations, over which the grant-making foundations have to exercise detailed 'expenditure responsibility' (IRC §§4945(d)(4), 4945(h)). In order to avoid the bother of expenditure responsibility, several grant-making foundations — including some with ample capacity to handle this responsibility — have simply stated that they will not make grants to *any* operating foundations, thus excluding some of the newly-established, fragile charities that most need foundation help.

Finally, there is the diversion of foundation resources to vendors of the goods and services needed to comply with the new regulatory requirements. For example, the Rockefeller Foundation, which had

been paying normal commercial rent in the Rockefeller Center, was forced by the self-dealing rules to move, and it was an expensive move ($2 million was one reported figure[11]). An exercise like this one diverts charitable funds to removal companies, furniture stores, architects, plumbers: all admirable institutions and individuals, but not the traditional objects of philanthropy. Newspapers, too, absorb charitable funds by selling space to foundations that must, under the 1969 Act, place advertisements announcing the availability of annual reports (IRC §6104(d)). And, of course, there are the lawyers and the accountants who find that the 1969 Act creates a splendid source of new business. Some of these lawyers told the Yale-Foundation Council interview team that the 1969 Act encouraged them to enter the field of non-profit practice.

Not all the items on this list of resource diversions are equally serious, but they are all worth noting. What deserves special attention is the strong likelihood that these diversions — particularly those caused by the excess business holdings rule and the appreciated property deduction rule — contributed to a notable phenomenon on which the Yale-Foundation Council study focused: a sharp decline in the birthrate of foundations. The high-water decade was the 1950s, when there were established 1,858 foundations that in 1995 held more than $1 million in assets or made $100,000 in annual grants. In the 1960s the birthrate decline had begun: 1,670 such foundations were formed. In the 1970s the figure plunged to 983. Perhaps this decline was only temporary: in the 1980s the rate increased markedly (3,082 formations), although we do not know how many will end up in the important category of the foundations with assets of more than $25 million (Renz et al., 1995, p.25).[12] Special transitory reasons may explain some of the 1980s growth (Yale University, 1988, p.8). In any event, the permanence of the 1980s upward trend is unknown: many foundations that came into existence in the 1970s and 1980s were created under pre-October 1969 wills, thus escaping the most stringent excess business holding rules; later testators with such business holdings presumably will have less incentive to create foundations.

Why should one worry about a declining birthrate? Because it limits the number of doorbells on which grant-makers can ring — particularly the number of large-scale sources of support for the introduction of new ideas and programmes or for the conservation of older values and traditions. (That is why the birthrate of foundations with more than $25 million has special significance.) Here, in the philanthropic marketplace, as in the commercial marketplace, *entry* is a healthy phenomenon, and barriers to entry should be a matter of great concern.

The overall impact of the 1969 Act would probably have been even more severe than this paper suggests had it not been for a remarkable

contrapuntal fact: Since 1969 there has been a steady course of *deregulation* (deregulation, incidentally, that has been a lot less destabilising than what has taken place in the airline industry).

First, Congress itself has deregulated. For example, as we have noted, Congress reduced the tax on investment income and cut back on the pay-out requirements. It also provided longer periods during which foundations could dispose of their 'excess business holdings' (IRC §4943(c)(2)), although these amendments did not remove the birthrate disincentives described above.

Second, the Treasury and IRS have engaged in what I view as a sophisticated and enlightened approach to the issuance of regulations implementing the 1969 Act. Treasury implementation of the anti-lobbying and speculative investment rules, for example, has provided a mild form of interpretive deregulation in these two areas,[13] and the IRS has been thoughtful and sensitive to the needs of the foundation community in its rulings.

Third, and perhaps more controversially, the Congress over the years has provided special relief to dozens of foundations from a variety of provisions — a form of *ad hoc* deregulation that may well be justified in individual cases but does not receive the public scrutiny it ought to have.

Finally, there has been some *underground* deregulation: a few foundations have engaged in what must be characterised as lawless conduct. At a meeting on voter registration activities in the mid-1980s, some programme officers of foundations in a major American city talked proudly about how they had evaded the 1969 Act's voter registration provisions — rules intended to preclude foundations from supporting 'rifle-shot' voter registration activity tilted toward selected candidates in selected election contests (IRC 4945(f)). The foundation representatives had flouted these non-partisan strictures by giving technically non-earmarked grants to a local church for the clear purpose of getting out the vote for a favoured local candidate.[14]

Conclusion

'Looking backward', as this paper is captioned, there are no really apocalyptic conclusions. The 1969 Act was not malevolent or corrupt legislation; it represented a great deal of hard work by bright and decent people; and it was in some respects modestly helpful. But Congress, acting in the presence of siege, was not at its best.

In my view, more deregulation (the above-board kind) is called for, in order to reverse some of the resource diversions that limit the health and strength of America's private foundation sector. In so

stating, I return to the Treasury's 1965 report. Despite the questions raised earlier in this paper, that report did capture the big point about private foundations. 'Foundations', the Treasury said, 'have enriched the pluralism of our social order.' Perhaps that is why in Hungary, a country pursuing increased pluralism, one saw the establishment of almost 1,000 foundations in the two-year period that *preceded* the 'Revolution of 1989'. And perhaps that is what the Psalmist had in mind, when he or she wrote in the 11th Psalm: 'If the foundations be destroyed, What can the righteous do?'[15]

Notes

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* This paper has its origins in a talk (never published) that was given at a conference entitled *Twenty Years Under the 1969 Act: Private Foundations 1969-1989*, held on 2 May 1989 at the Association of the Bar of the City of New York.

1 43 Eliz. I, ch. 4 (1601).

2 Pub. L. No. 91-172, 83 Stat. 498 (1969). The provisions of this Act now appear in several sections of the Internal Revenue Code of 1986, Title 26, United States Code. (The Internal Revenue Code of 1986 is hereinafter referred to as 'IRC' or the 'Code'.)

3 These provisions are contained in IRC §§170(e)(1)(B)(ii), 509, and 4940-4946.

4 I have heard this anecdote on good authority but have never found a published account.

5 As one of the participants in this negotiation, I am the source for this information.

6 'Program-related investing' involves a foundation's use of investments rather than outright grants to further charitable purposes, where a financial return is not the dominant reason for the investment. Examples are a loan that permits an early start to a university's building programme or the provision of equity capital to launch a low-income housing venture.

7 See, for example, the result of a recent effort of simplification: the Revenue Act of 1986.

8 The 1965 Treasury report offered a Federal-largesse rationale that is discussed in Simon (1965, p.170, note 66).

9 IRC §501(c)(3) ('substantiality' test) and §§501(h), 4911 (further liberalisation of the lobbying rules).

10 Conversation between the author and an anonymous Washington DC lawyer.

11 The report was made to the author by an officer of another Rockefeller-related charity.

12 The data for the 1990s are too incomplete to analyse, although a preliminary look suggests that the 1990s birthrate may lag behind that of the 1980s.

13 Treasury Regulations §§53.4944-1 (investments), 53.4945-2 (lobbying).

14 The author was present at the meeting and registered a protest on grounds of law obedience and prudence — without any detectable response.

15 But the Psalmist also wrote: '[A]ll the foundations of the earth are out of course' (Psalms 82).

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