A DUBIOUS DISTINCTION: RETHINKING TAX TREATMENT OF PRIVATE FOUNDATIONS AND PUBLIC CHARITIES

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TABLE OF CONTENTS

I. INTRODUCTION AND BACKGROUND .............................................. 138
   A. The Diverse Foundation Community in America ....................... 140
   B. A Short History of American Foundations ............................... 142

II. TAX DISTINCTIONS BETWEEN PRIVATE FOUNDATIONS AND
     PUBLIC CHARITIES ........................................................................ 148
    A. Deductibility of Charitable Contributions (Section 170) .......... 155
    B. Excise Taxes on Investment Income .......................................... 156
    C. Prohibitions on Self-dealing (Section 4941) ......................... 157
    D. Minimum Distribution Requirements (Section 4942) .................. 157
    E. Restrictions on Excess Business Holdings (Section 4943) ......... 159
    F. Prohibitions on Speculative Investments (Section 4944) .......... 160


IV. THREE PHILANTHROPIC VEHICLES: PROS AND CONS .................... 166
    A. Independent Foundations / Private Foundations ...................... 166
    B. Community Foundations ....................................................... 169
    C. For-Profit Charitable Funds .................................................. 174

V. PROPOSALS FOR REFORM .............................................................. 178
    A. Recent Proposals for Reform ................................................. 178
    B. A Call to Restructure the Paradigm to Address Donor
       Control .................................................................................. 179
    C. Reconfigure the Excise Tax on Private Foundations .............. 184

* Associate, Ice Miller, Indianapolis, Indiana; Indiana University, B.A., 1995; Harvard
  School for his guidance in developing this article and to Dr. Edward Queen for introducing
  me to the issues addressed herein. Thanks also to my husband, Blane Sherman, for his
  constant patience, love, and support.
VI. CONCLUSION........................................................................................................186

I. INTRODUCTION AND BACKGROUND

The American nonprofit sector\(^1\) has its origins in the 1601 Statute of Charitable Uses in which Queen Elizabeth I authorized the establishment of private perpetual funds to support specific religious and charitable institutions.\(^2\) These perpetual foundations were and are somewhat remarkable in a legal tradition that places restrictions on a dead man's ability to control his wealth from beyond the grave.\(^3\) The public benefit and the religious roots of philanthropy justify such exceptions to the rationale underlying the Rule Against Perpetuities.\(^4\) Perhaps due to the great cultural respect for altruism and "good works," the American legal system largely has neglected or refused to govern nonprofit organizations outside of the purview of the Internal Revenue Code (Code).\(^5\)

Since Queen Elizabeth I's day, the definition of a foundation has been most simply a perpetual gift to benefit a particular charity or group of deserving persons.\(^6\) Such an expansive definition could encompass the

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\(^1\) Also known as the "third," "philanthropic," "voluntary," or "independent" sector.
\(^2\) See 43 Eliz., c. 4 (1601) (Eng.). The Queen's action was in part an apology for her father Henry VIII's infamous seizure of the monasteries and property of the Roman Catholic Church and decree that all ecclesiastical foundations held their assets only in trust for the Crown. For an overview of Elizabeth's reign, including descriptions of the state of England and its people during this time, see generally ALISON WEIR, THE LIFE OF ELIZABETH I (1998).
\(^4\) "[N]o interest in property is good unless it must vest, if at all, not later than 21 years, plus period of gestation, after some life or lives in being at time of creation of interest." BLACK'S LAW DICTIONARY 1331 (6th ed. 1990).
\(^6\) A foundation is a "[p]ermanent fund established and maintained by contributions for charitable, educational, religious, research, or other benevolent purpose." BLACK'S LAW
entire nonprofit sector. However, when Congress authored the current regulations concerning the nonprofit sector in 1969, it divided the traditional foundation category into two parts. Congress perceived a sharp division between private foundations, such as the high profile Ford Foundation, Carnegie Corporation, and Kellogg Foundation; and public charities, organizations that the public more broadly supports through donations, such as the Salvation Army, Red Cross, and California Community Foundation. Congress intended the private/public distinction to serve as a proxy for the amount of control a donor retained over her gift after dedicating it to philanthropy and taking the corresponding tax deduction. In the past three decades, the statutory law has remained relatively static. The reality that informed the 1969 categorizations, however, changed dramatically, blurring the lines between private and public, which in turn undermined the validity of the distinction. The growing popularity of community foundations and for-profit charitable funds, coupled with the looming generational transfer of Baby Boomer wealth, has led to greater philanthropic opportunities for middle-income families in what has been called a "democratization of dynasty."

The increasing importance of community and for-profit forms of foundations, which the Code classifies as public charities even though donors may retain significant control over their gifts, also raises fundamental questions about federal tax treatment of foundations and the legitimacy of the paradigmatic private/public distinction as a proxy for donor control.

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8 At least three financial services companies, including Charles Schwab, Fidelity Investments, and Vanguard, have created for-profit charitable funds that give the donor practically unfettered control over investment vehicles, successors to their accounts, and benefiting charities. See Arthur M. Louis, Budding Philanthropists, S.F. CHRON., Feb. 29, 2000, at C1; see also Guy Halverson, Make Gifts Grow Before They Go to Charity, CHRISTIAN SCI. MONITOR, Dec. 6, 1999, at 20; Mary Williams Walsh, Philanthropy Is Good Business for Gifts Fund, L.A. TIMES, Dec. 30, 1999, at A1.

9 See generally Evelyn Brody, Charitable Endowments and the Democratization of Dynasty, 39 ARIZ. L. REV. 873 (1997); Gene Steuerle, Charitable Endowments, Advised Funds & the Mutual Fund Industry – Part One: A New Democracy of Endowment Giving, TAX NOTES TODAY (Jan. 4, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 1-67) (arguing that "the mutual fund industry has expanded dramatically the number of endowed programs in society and fundamentally changed the nature of philanthropic or endowed giving" and that "the democratization of endowment giving is an exciting prospect").
This article maps the terrain of the American foundation in 2002, outlines and analyzes current Code provisions that relate to foundations, critiques the Bush Administration’s proposal to modify the excise tax on private foundations, and proposes fundamental changes to the Code to bring it in line with modern challenges and realities.

A. The Diverse Foundation Community in America

Commentators describe foundations as “a special American phenomenon.”10 American philanthropists are indeed responsible for tweaking the traditional foundation model into a number of innovative designs. While the Code breaks the nonprofit sector into only two pieces, professionals in the field have identified five types of foundations.11 The first three categories of foundations fall under the Code’s definition of private foundations, and the last two are public charities.12

The independent foundation category, created by the Council on Foundations to include trusts created by individuals or families, is the largest of the five.13 Most independent foundations have an endowment and make grants out of investment income. Although these entities start out with close ties to the donors who created them, after a few generations, they tend to develop a more independent character and rely more heavily on professional staffs and trustees. This category includes some of the largest, most well-established players in the nonprofit sector, including the Ford Foundation, the Rockefeller Foundation, and the Lilly Endowment. It also includes quite modest family foundations with assets of less than $100,000. Generally, independent foundations do not support the same group of charities year after year. Instead, they engage in programmatic grantmaking.14 There are over 40,000 private foundations in the United


12 See FREEMAN, supra note 11, at 6.

13 See id. at 7.

14 For example, the Doris Duke Charitable Foundation, which has assets of approximately $1.5 billion, limits its grant-making to the areas of performing arts, conservation of the environment, and medical research. Doris Duke Charitable Found., Mission, at http://fdncenter.org/grantmaker/dorisduke/ic/mission/index.html (last visited Apr. 11, 2002). The Pew Charitable Trusts, on the other hand, has a broader range of interests and funds grants in the areas of culture, education, environment, health and human services, public policy, and religion. See Pew Charitable Trusts, Grants Information, at http://www.pewtrusts.org/grants/index.cfm (last visited Apr. 10, 2002).
States, and the Council on Foundations estimates that donor families actively manage two-thirds of those.\footnote{See JAMES J. FISHMAN \& STEPHEN SCHWARZ, NON-PROFIT ORGANIZATIONS: CASES AND MATERIALS 610 (2d ed. 2000).}

Corporate foundations are legally indistinguishable from independent foundations, but, as their name suggests, corporations create and fund them. Corporate foundations are separate entities from their parent companies and rarely have large endowments. Instead, they normally function on a pass-through basis, receiving some portion of the corporation’s profits each year. The funding company usually employs the trustees and staff of corporate foundations so the charitable goals of the foundation are continuously tied to the best interests of the company.\footnote{Examples include the Coca-Cola Foundation, which is focused on scholarships and education grants, and the Shell Oil Foundation Company, which “focuses on making a difference in the communities where Shell people work and live.” Shell Oil Co., Shell Oil Company Foundation, at http://www.countonshell.com/community/involvement/shell_foundation.html (last visited June 14, 2002); see also Coca-Cola Co., Coca-Cola Foundation, at http://www2.coca-cola.com/citizenship/foundation_coke.html (last visited June 14, 2002). See generally Found. Ctr., Finding Funders: Web Sites of Corporate Grantmakers, at http://fdncenter.org/ funders/grantmaker/gws_corp/corp1.html (last visited June 14, 2002).}

An operating foundation is a private foundation that primarily funds its own programs instead of engaging in grantmaking to public charities.\footnote{I.R.C. § 4942(j)(3)(A) (1999) (defining “operating foundation” as any organization “which makes qualifying distributions . . . directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated”)} Examples of this category include the J. Paul Getty Trust, which built a fabulous museum in Los Angeles, and the Longwood Gardens in Pennsylvania, which is dedicated to horticulture. Operating foundations are quite similar in structure and origin to independent foundations but receive some tax benefits that private foundations do not.\footnote{See Treas. Reg. § 53.4942-3.}

The Code classifies the fourth kind of foundation, the community foundation, as a public charity rather than as a private foundation. Thus, community foundations are subject to fewer regulations and taxes than their private counterparts. Donations to community foundations are also subject to more favorable levels of deductibility than gifts to private foundations. While a single source generally funds independent foundations, corporate foundations, and operating foundations, community foundations have multiple sources of funding. As their name implies, community foundations also focus their grantmaking on a particular geographic area, which is normally a city or county. In less populated areas, however, the region may be larger. Community foundations are distinguished from other
types of foundations by close ties to their communities, not only in grantmaking but in management as well. Normally, local institutions and officials appoint trustees and grantmaking committees that create a level of local accountability. There are more than 660 community foundations in the United States today.\textsuperscript{19} While established community foundations in urban areas—like New York City, Cleveland, and Chicago—have impressive assets, most community foundations have modest endowments and are still quite new.

The final type of foundation, the public foundation, also receives public charity rather than private foundation status under the Code even though they engage in grantmaking. Like community foundations, public foundations receive funds from multiple sources rather than a single donor, and such public support entitles them to favorable tax treatment. Traditionally, public foundations, like the Philadelphia Bar Foundation and Haymarket People’s Fund, raised money for specific causes and then distributed it annually.\textsuperscript{20} Many of the funds created in the wake of the September 11, 2001 terrorist attacks are public foundations.\textsuperscript{21} This category may also include the new for-profit charitable funds created and managed by investment companies like Fidelity Investments and Charles Schwab.

**B. A Short History of American Foundations**

Wealthy Americans always have contributed generously to their communities, especially funding the establishment and perpetuation of churches, hospitals, and schools; however, organized and national philanthropy in the United States did not begin in earnest until the Industrial Revolution enabled individuals to amass great fortunes.\textsuperscript{22} Some of these self-made millionaires, most famously the steel tycoon Andrew Carnegie, believed that the accumulation of wealth carried the moral imperative to improve the conditions of society.\textsuperscript{23} A number of wealthy robber barons

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\textsuperscript{21} See Office of the New York State Attorney General, WTC Relief Info, at http://www.wtcrelief.info/Charities/Information/pages/Results.jsp (last visited Apr. 12, 2002).

\textsuperscript{22} See Odendahl, supra note 6, at 1.

\textsuperscript{23} See Andrew Carnegie, The Gospel of Wealth, in 1 THE GOSPEL OF WEALTH AND
used their fortunes to establish foundations they hoped would promote their "personal visions of . . . society" in perpetuity.\textsuperscript{24}

While American philanthropists established only five general foundations in the nineteenth century, Carnegie and John D. Rockefeller not only inspired a generation of tycoon-philanthropists, but they invented the organized philanthropy of the twentieth century. Both Carnegie and Rockefeller believed that philanthropy, as opposed to personal charity, required knowledge, skills, and a professional staff. These pioneers also believed that by funding scientific research and endowing institutions they could eliminate social ills.\textsuperscript{25}

The first four decades of the twentieth century gave birth to large numbers of foundations, including the W.K. Kellogg Foundation in 1930,\textsuperscript{26} and the Lilly Endowment in 1937.\textsuperscript{27} The prosperity of the decade following World War II encouraged the endowment of a number of large foundations, like the Ford Foundation.\textsuperscript{28} In the 1950s, the foundation movement exploded and the number of foundations with assets of more than $1

\textsuperscript{24} Odendahl, \textit{supra} note 6, at 1.

\textsuperscript{25} As John D. Rockefeller wrote, "The best philanthropy involves a search for cause, an attempt to cure evils at their source." \textsc{Raymond B. Fosdick, The Story of the Rockefeller Foundation} 22 (Transaction Publishers 1989) (1952). One example of the Rockefeller Foundation's philosophy can be seen in its approach to the problem of third world hunger in the 1950s and 1960s. The Foundation

created research institutes that developed new strains of wheat and rice that doubled and tripled crop output per acre.

Within six years, India doubled its rice production, and Mexico, once an importer of wheat, became an exporter. Nigeria and Colombia created their own research institutes modeled on the foundations' research. The Rockefeller Foundation subsequently disseminated its results to organizations from 28 developing countries. Altogether, many millions of the world's poorest people benefited from the knowledge created by [the Rockefeller and Ford Foundations].


\textsuperscript{27} \textsc{See The Encyclopedia of Indianapolis} 914 (David J. Bodenhamer & Robert G. Barrows eds., 1994).

million doubled. The tax structure in place in the middle of the twentieth century made foundations an attractive shelter for great wealth, and too many pseudo-philanthropists received tax benefits without actually engaging in philanthropy. These very public manipulations drew the attention of Congress, which passed the Tax Reform Act of 1969 (1969 Act) in order to rein in private foundations.

After Carnegie and Rockefeller set the precedent for professional philanthropy with their personal foundations, cities throughout the country began to adapt the model to their own needs and strengths. The first of these community foundations was created in Cleveland in 1914. The structure of the new Rockefeller Foundation particularly influenced Cleveland banker Frederick H. Goff, who envisioned this new entity.

Mr. Rockefeller'[s]... investments in charity as in business are made to secure the maximum of return... If Mr. Rockefeller had not believed in the value of large units for handling charitable gifts, he would have created, say, a thousand separate trusts of one hundred thousand dollars each... The advantage [of a large foundation] would be immeasurably [clearer] if we were to conceive of the multitude of small trusts being created by different individuals, for the most part unhappily lacking the genius of Mr. Rockefeller in planning charitable trusts to endure for all time... Recognizing his inability to foresee the needs of mankind in future ages, he imposed no restriction and made no suggestion as to how either interest or principal should be used.

Thus, Goff encapsulated the case for community foundations: professional trustees could more efficiently manage a large endowment made up of a number of small gifts as a whole. By focusing the

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29 See Odendahl, supra note 6, at 21.
32 Id. at 29.
33 This rationale clearly motivated the citizens of other cities who founded their own community foundations. See CAL. CMTY. FOUND., BUILDING A FOUNDATION FOR THE FUTURE 1 (n.d.) ("The California Community Foundation was a management decision, not a philanthropic one... This was a plan to pool small philanthropic trusts and funds under one entity for management efficiency and economies of scale—which became a community of donors, or a community foundation."). Jack Shakely, president of the California Community Foundation, summarized the attributes of community foundations:

While each community foundation has its own distinct personality and style,
foundation on a single community while maintaining the broadest charitable
purposes, the community foundation would have the ability to adapt to
changing times and to address the “needs of mankind in future ages.”
Goff’s idea took off, and by 1930 twenty-one American cities had
community foundations with assets of more than $100,000. Today, over
660 community foundations exist. Through the community foundation,
even the most modest philanthropists are able to contribute to a
Rockefeller-type foundation focused on the long-term needs of their
communities. Although the historical evolution of these foundations has
been tied to community, there is no theoretical reason why a national
community-type foundation, perhaps limited to a particular issue or issues,
could not be designed.

all share several attributes:

- Community foundations exist so individuals and families can establish
  a charitable fund without having to cope with the tax liabilities and
  administrative hassles of setting up a private foundation.

- Each community foundation functions, in effect, as a philanthropic and
  grantmaking collective. A unique characteristic of community
  foundations is that they allow donors to personalize their giving. At the
  same time, however, a community foundation pools all of its funds to
  achieve a greater return on investments, making it possible for
  individual, small funds to make more powerful contributions to a
  charitable cause than they could on their own. For example, a
  community foundation might make a single grant for development of
  low-income housing that includes money from a half-dozen different
  individual funds focused on the same field.

- Each community foundation is headquartered in and serves a specific
  locale. Accordingly, a community foundation is a locally managed
  organization with a fund base reflecting the imperatives of the
  community itself. But its donors can choose to make grants anywhere
  they want in the country if they wish.

In short, a community foundation brings the power of endowment funding,
its expertise in grantmaking, and the personal quality of an individual’s spirit of
caring together to benefit others, now and forever.

84, 84.

34 TITTLE, supra note 31, at 29. See supra text accompanying note 32.
35 See Thomas J. Billitteri, Donors Big and Small Propelled Philanthropy in the 20th
36 See Columbus Found., supra note 19..
37 The “single entity” rule discussed infra footnote 178 permits treatment of the
community foundation as a public charity. There is nothing in the regulations that requires a
A community foundation now serves nearly every major city in the United States. As a whole, community foundations have experienced tremendous growth in the past two decades. A 1999 survey by the Columbus Foundation noted that the assets of community foundations exceeded $25 billion in 1998, a nineteen percent increase over 1997. A healthy economy and a general rising trend in philanthropic giving are responsible for part of this increase. In 2000, Americans donated $203.45 billion to nonprofit organizations, a 6.6% increase over 1999. This figure represents a steady annual increase in individual philanthropy since 1995 that far outpaces inflation. Noting the popularity of philanthropy and some of the unique benefits offered by community funds, investment companies decided to become involved in philanthropy in the early 1990s. They pioneered the last important type of American foundation of the twentieth century: the for-profit charitable fund.

Fidelity established the Fidelity Investments Charitable Gift Fund in 1992. Clients of Fidelity can make irrevocable, tax-deductible contributions to the fund and recommend which charities should receive

community foundation to limit fundraising or grantmaking to a particular geographic area, although tradition strongly suggests such a limit. See Treas. Reg. § 1.170A-9(e)(10) (as amended in 2002) (“Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area. . . .”) (emphasis added). The regulation does not define “community” or limit it to geography. The formation of the National Catholic Community Foundation (NCCF) in 1997 may mark the beginning of the nationalization of the community foundation model.

NCCF has adapted the popular community foundation concept to the national level, redefining “community” as a community of people rather than geography. NCCF allows for funding tax-exempt activities anywhere within the United States, and also in some circumstances internationally. The only stipulation is that neither the fund purpose nor disbursement can be in conflict with the teachings of the Roman Catholic Church.


40 In 1996, Americans donated $133.5 billion and, in 1997, $143.5 billion. See Marilyn Dickey & Domencia Marchetti, Donations to Charity Rise 7.5%, CHRON. OF PHILANTHROPY, June 4, 1998, at 1.

41 See Halverson, supra note 8.
grants from the income and/or principal of their accounts. For a fee, which depends on the balance of the fund and the level of annual activity, Fidelity Investments pools and manages individual donor’s funds. Individuals may choose to make periodic gifts, or, as many do, they may choose to delay any distributions until their contributions have reaped healthy returns.\textsuperscript{42} Although the Fidelity plan originally allowed donors nearly unbridled discretion in grantmaking, it has since voluntarily instituted rules that prohibit donors from funneling money to private foundations or foreign charities.\textsuperscript{43} Fidelity currently has a list of 700,000 public charities that are qualified to receive funds from individuals participating in its Gift Fund.\textsuperscript{44}

Fidelity’s Gift Fund has become a great success in monetary terms. By June 30, 2001, the fund controlled $2.65 billion in assets of 27,601 individual donors, making it the largest donor-advised fund and the second-largest public charity in the United States.\textsuperscript{45} Inspired by Fidelity’s success, a number of other investment companies, including T. Rowe Price, Vanguard, and Charles Schwab, started their own for-profit charitable funds.\textsuperscript{46}

These financial services companies promote their funds by stressing that individual donors receive much of the flexibility inherent in the independent foundation model without the negative tax consequences of private foundation status since the Code treats for-profit charitable funds like public charities.\textsuperscript{47} Individuals maintain a remarkable amount of control over their donations to these funds—choosing investment vehicles, the timing of gifts, and ultimate recipients. To a lesser extent, individuals who establish donor-advised funds with community foundations maintain similar control over their donations and receive the tax benefits of public charity

\textsuperscript{42} See Louis, supra note 8.

\textsuperscript{43} See Monica Langley, Fidelity Plans to Limit Donors’ Ability to Benefit from Gifts to Public Charity, WALL ST. J., July 14, 1998, at A4.

\textsuperscript{44} Essentially, all section 501(c)(3) organizations other than private foundations are eligible to receive donations. See Halverson, supra note 8.


status.

As this brief historical sketch hopefully makes clear, the world of American foundations has gone through dramatic changes in the twentieth century. At the beginning of the century, to speak of foundations meant to speak of independent foundations established by wealthy individuals and families like the Rockefellers. When Congress enacted the 1969 Act, the independent foundation still typified the American foundation. The slow and steady rise of community foundations through the century had little effect on that standard probably because their number and total assets were comparably insignificant. In contrast, the past two decades brought explosive growth in both the number of community foundations and their endowments. In the 1990s, the mercurial rise of for-profit charitable funds also strained the Code’s private/public distinction as a proxy for donor control. The increasing popularity of both types of foundations demands that we examine the ramifications of the designations of private foundation and public charity. It demands that we reconsider the dated private/public paradigm in the Code and ask whether changes need to be made to the Code to allow it to reflect the state of American philanthropy in the year 2002.

II. TAX DISTINCTIONS BETWEEN PRIVATE FOUNDATIONS AND PUBLIC CHARITIES

In the decades after World War II, economic expansion, high income tax rates, and significant estate taxes fueled an explosion in the number of private foundations. While most of the new foundations were legitimate charitable enterprises, many were little more than abusive tax shelters. In 1950, President Harry S. Truman captured public anger at those manipulating the system when he complained to Congress that private foundations were “a cloak for speculative business ventures.”

Public sentiment encouraged Congress to pass the first real effort to regulate nonprofit organizations through the Code. In order to discourage people from using foundations for private gain, Congress moved to revoke section 501(c)(3) status from “charities that engaged in ‘prohibited transactions’ (specified acts benefiting substantial contributors), or whose undistributed income was unreasonable in amount or duration, used to a substantial degree for nonexempt purposes, or invested in a manner

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49 Billitteri, supra note 35.
jeopardizing their exempt purposes." Congress exempted several types of traditional charities (e.g., schools, churches, hospitals) but did not attempt to justify why these organizations should not be covered by the new restrictions. By asserting that the new self-dealing rules were applicable to 'organizations which are manipulated to the private advantage of [their] substantial donors,' the 1950 committee reports implied that charitable organizations subjected to these rules were more prone to this type of abuse than those exempted. This language suggests that as early as 1950, Congress recognized distinctions between different types of nonprofit organizations and their varying levels of vulnerability to abuse by donors. The beginning of the private/public distinction as a proxy for the pivotal variable, level of donor control, originated in this 1950 legislation.

Congress further amended the Code in 1954 and 1964 in efforts to distinguish between categories of charitable organizations to a greater degree and to prevent various subversions of charitable intent. In 1954, when Congress raised the ceiling on an individual taxpayer's deduction for charitable contributions from twenty percent of adjusted gross income to thirty percent, only churches, educational institutions, and hospitals could utilize the extra ten percent. In 1964, Congress allowed donations to all "publicly supported" charities to be deductible up to the thirty-percent ceiling. The Senate committee report explained that the new definition excluded private foundations because legislators intended the extra ten-percent deduction to "encourage immediately spendable receipts of contributions for charitable organizations."

Congress's changes to the Code in 1954 and 1964 rely on a perceived distinction between private and public charities, which were rooted in a


51 See Bittker, supra note 50, at 141.

52 Id.; see also H.R. REP. NO. 81-2319, at 36-43 (1950).

53 The rationale for these changes is explained in the committee reports. See S. REP. NO. 83-1622, at 29 (1954); see also H.R. REP. NO. 83-1337, at 25 (1954).

54 S. REP. NO. 88-830, at 58 (1964). This legislation raises an important distinction between grantmaking foundations and public charities that directly benefit society: the former are perceived as possibly less of a social good because society receives the benefit of the philanthropic dollars more slowly. Some argue that since tax deductions are granted in the year in which donations are made, the benefit to society should quickly follow the forfeited tax. See generally Porter & Kramer, supra note 25.
number of assumptions that favored the public grouping over the private. Charities that receive their support from a number of donations rather than from a single source, for example, could be considered to have a public mandate for their activities. The rationales for the 1954 and 1964 legislation foreshadowed the sweeping changes that came in 1969.

The 1969 Act, which is imbedded in the Code and administered by the Internal Revenue Service (Service), is primarily regulatory legislation aimed at private foundations despite the trappings of tax legislation. Its enactment represented a major departure from the laissez-faire attitude that had long characterized the American government's relationship with the nonprofit sector and instituted a number of rules aimed at curbing the abuses noticed by President Truman and Congress as early as 1950.

To populists, private foundations represented the arrogance and greed of a wealthy, mainly East Coast, elite. In 1961, Representative Wright Patman, a Democrat from Texas, began a series of high-profile investigations into the activities of private foundations. Patman and his supporters concluded that large foundations without countervailing accountability possessed too much financial and political power and that wealthy Americans were using foundations to abuse tax laws. At Representative Patman's insistence, the Treasury Department investigated private foundations but concluded in a 1965 report that most private foundations did not abuse the tax system and did fulfill an important social function. However, the Treasury Department did identify several problems in the private foundation world that justified congressional attention, including dangerous concentrations of economic and social power in private foundations, instances of donors and their families using foundations for private gain, inappropriate business holdings by foundations, and an "undue lag between the charitable gift generating the tax benefit (the transfer of wealth to the foundation) and the use of the funds for charitable purposes." Although the 1965 Treasury report identified only modest problems, it encouraged Representative Patman's committee to issue new reports in 1966, 1967, and 1968, which "presented a stream of new allegations and cases of flagrant foundation misconduct."

57 See generally WALDEMAR A. NIELSEN, THE BIG FOUNDATIONS (1972); FOUNDATIONS UNDER FIRE (Thomas C. Reeves ed., 1970); Ylvisaker, supra note 11; Billitteri, supra note 35.
58 FISHMAN & SCHWARZ, supra note 15, at 613.
59 NIELSEN, supra note 57, at 8.
On February 18, 1969, Representative Patman’s personal crusade took on new significance when the House Ways and Means Committee opened hearings on the question of tax-exempt foundations. Representative Patman was the first witness before the Committee, and he set the tone for the discussion:

Today, I shall introduce a bill to end a gross inequity which this country and its citizens can no longer afford: the tax-exempt status of the so-called privately controlled charitable foundations, and their propensity for domination of business and accumulation of wealth.

Put most bluntly, philanthropy—one of mankind’s more noble instincts—has been perverted into a vehicle for institutionalized, deliberate evasion of fiscal and moral responsibility to the nation.

This has been accomplished by tax immunities granted by the U.S. Congress. The use of the tax-free status . . . reveals the continuing devotion of some of our millionaires to greed, rather than conversion to graciousness.

Mr. Chairman, when a privilege is abused, it should be withdrawn. And the onerous burdens of 65 million taxpayers demand that Congress curb the tax-exempt foundations which, in unwitting good faith, it helped to create.60

On the second day of the hearings, Representative John J. Rooney, a Democrat from New York City, testified that private foundations could be used to undermine democracy.61 In a previous campaign, explained Representative Rooney, a wealthy opponent used his own private foundation to make tax-free donations to politically influential groups to encourage them to get out the vote. Thus, his opponent’s campaign was “subsidized by all United States taxpayers and in defiance, if not in violation, of laws governing campaign moneys.”62 Representative Rooney warned the committee that the same thing “can—and probably will—happen in your districts. In fact, the appeal of this political gimmick is a threat to every officeholder, in Congress or elsewhere, who does not have access to a fat bankroll or to a business or to a tax-exempt foundation.”63

On the third day, Ford Foundation president McGeorge Bundy was scheduled to testify.64 The testimony of Representatives Rooney and

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60 Id. at 9-10.
61 See id. at 10.
62 Id.
63 Id.
64 See id. at 10-12.
Patman raised a number of questions for committee members. To make matters worse, Bundy was one of the most controversial figures in the philanthropic world in 1969. Under his leadership, the Ford Foundation gave money to organizations to support efforts to increase African-American voter registration and assisted an allegedly militant Mexican-American organization to enter local politics. Only a week before the hearings began, The New York Times reported that the Ford Foundation made grants totaling $131,000 to eight prominent members of the late Senator Robert F. Kennedy’s staff. According to a Ford Foundation press release, they intended these grants, personally approved by Bundy, “to ease the transition from public to private life [by providing] up to a year of leisure and freedom from immediate financial concern.”

The committee members began by firing questions at Bundy regarding the Kennedy staff grants. He attempted to defend the grants as purely “educational” rather than personal or political—an argument undermined both by common sense and the Ford Foundation’s own press release. Throughout his testimony, Bundy “conveyed a strong impression of arrogance and condescension.” One congressman remarked, “I went into that hearing this morning basically friendly to the foundations; I came out feeling that if Bundy represents the prevailing attitude among them, they are going to have to be brought down a peg. For all their Ph.D.’s they are not above the law.”

Although the turbulent first days of the hearings gave way to more sober testimony and reflection by committee members, the tone had been set and the perceived privileges and excesses of private foundations were under attack. Eventually, Congress drafted legislation with the intent of curbing the power, influence, and flexibility of private foundations. The House and Senate passed different versions of the tax bill, and a conference committee hammered out a compromise act. After much deliberation, Congress finalized the 1969 Act on December 23, 1969.

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66 See Nielsen, supra note 57, at 11.
67 See id.
68 Id.
69 See id. at 12.
70 See id.
71 Id.
72 Id.
73 See id. at 17.
The 1969 Act is significant because it erected the modern structure of regulations and taxes governing the nonprofit sector. Section 501(c)(3) of the Code establishes that certain organizations that operate exclusively for charitable and other specified purposes are exempt from federal income tax.\textsuperscript{74} Within the category of section 501(c)(3) organizations, the Code further distinguishes between public charities and private foundations.\textsuperscript{75} Section 509 treats every section 501(c)(3) organization as a private foundation unless it falls into one of three categories: so-called traditional charities, broad publicly supported organizations, or supporting organizations.\textsuperscript{76}

Defined by section 170 of the Code, the first category qualifying for exclusion from private foundation status is a group of organizations echoing the Elizabethan definition of charity: churches, educational institutions, hospitals, and organizations supported by the government and/or the public.\textsuperscript{77}

To qualify as a publicly supported organization under section 509 or section 170, an organization must pass one of two public support tests.\textsuperscript{78} The mechanical test relies on the construction of a fraction: public support over total support.\textsuperscript{79} Donations to the organization that qualify as public support must equal or exceed one-third of gross support in order to pass the mechanical test.\textsuperscript{80} The rules regarding what constitutes public support are somewhat complex, but the term generally includes contributions from individuals, foundations, or corporations, grants or gifts from governmental units, and membership dues unless those dues are used to pay for

\textsuperscript{74} Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3).

\textsuperscript{75} See Williams & Moorehead, supra note 50, at 2100.

\textsuperscript{76} See id.; see also I.R.C. § 509(a)(1)-(3).


\textsuperscript{78} See John A. Edie, First Steps in Starting a Foundation 7 (3d ed. 1993); see also


\textsuperscript{79} See Edie, supra note 78, at 7.

\textsuperscript{80} See id.
admission, merchandise, services, or the use of facilities.\textsuperscript{81} Some types of support, including investment income, contributions or dues from individuals, foundations, or corporations that exceed two percent of total support in the relevant period; and income from unrelated business activities must be included in the gross support figure but may not count as public support.\textsuperscript{82} Income that comes from the exempt functions of the organizations is not included in either public support or total support.\textsuperscript{83}

If an organization's public support falls short of the required one-third fraction, it may still qualify as a public charity under the facts and circumstances test.\textsuperscript{84} To qualify under this test, an organization must meet three criteria: (1) the total amount of governmental or public support must be equal to or greater than ten percent of total support; (2) the organization must be organized and operated to attract new and additional support from the public and government; and (3) the facts and circumstances of the charity’s structure and programs must demonstrate that it should be recognized as public rather than private.\textsuperscript{85}

The third category of organizations that are exempt from private foundation status are supporting organizations.\textsuperscript{86} As their name implies, these entities are organized and controlled for the benefit of another public charity. Even though they may be, and usually are, endowed by an individual or family, their close relationship with a public charity allows them to escape private foundation status. Community foundations and institutional charities, such as colleges and churches, often enlist supporting organizations.\textsuperscript{87}

Organizations that do not fall into any of these categories are designated as private foundations and, accordingly, are subject to a number of provisions not applicable to the remainder of the nonprofit sector: the deductibility of charitable contributions; excise taxes on investment income; prohibitions on self-dealing; minimum distribution requirements; restrictions on excess business holdings; and prohibitions on speculative investments.

\textsuperscript{81} See id.

\textsuperscript{82} See id.; see also I.R.C. § 509(a)(2). For more detail, see Treas. Reg. § 1.509(a)-2 (1972).

\textsuperscript{83} See EDIE, supra note 78, at 7.

\textsuperscript{84} See id.

\textsuperscript{85} See id.; see also Treas. Reg. § 1.509(a)-2.

\textsuperscript{86} See I.R.C. § 509(a)(3).

\textsuperscript{87} See discussion infra note 181, for more detail on supporting organizations.
A. Deductibility of Charitable Contributions (Section 170)

The Second Revenue Act of 1917 first allowed taxpayers to deduct contributions made to certain charitable organizations. The Act limited deductions to fifteen percent of the taxpayer's taxable income until 1952 when the limitation increased to twenty percent. In 1954, taxpayers obtained the ability to deduct an additional ten percent for contributions to churches, schools, and hospitals. Since Congress introduced that additional layer of complexity in 1954, the deductibility limits of charitable contributions have depended on the tax status of the recipient organization.

The 1969 Act built upon this precedent of favoring some charities over others and created a tiered system of deductibility that differentiated between gifts of cash and appreciated property. The general limit increased from twenty percent to fifty percent for public charities only. Cash donations to private foundations were subject to a stricter limit of twenty percent. Deductible contributions of appreciated property to public charities were limited to thirty percent of the taxpayer's "contribution base" or adjusted gross income, but such contributions to private foundations were restricted by the twenty-percent limit. While donors of appreciated property could deduct gifts to public charities at their full fair market value, consequently receiving a deduction for unrealized and untaxed capital gains, donors of the same property to private foundations could deduct only cost plus sixty percent of the gain. Although donors to public charities who exceeded the ceilings for deductibility could carry over the excess for an additional five years, donors

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89 See id. at 2145.
90 See id.
91 See generally id. at 2145-51 (discussing percentage limitations on amount of deduction).
92 See Conrad Teitell, Tax Primer on Charitable Giving, TR. & EST. CHARITABLE GIVING SUPPLEMENT, June 1999, at 8, 8-10 (explaining, in great detail, the various rules regarding valuation of donated property and levels of deductibility for gifts to public charities and private foundations).
93 See Wallace & Fisher, supra note 88, at 2146.
94 See id.
96 See Edie, supra note 95, at 55.
to private foundations did not receive a similar privilege.\textsuperscript{97} Thus, the hierarchy of deductibility created under the 1969 Act favored donations to public charities in terms of limitations, valuation of capital gains property, and carryover rules.

In the Deficit Reduction Act of 1984, Congress revisited section 170 and made three significant changes.\textsuperscript{98} First, cash gifts to private foundations were deductible up to thirty percent, rather than twenty percent, of adjusted gross income.\textsuperscript{99} Second, gifts to private foundations were eligible for the five-year carryover provision previously available only for gifts to public charities.\textsuperscript{100} Third, gifts of publicly traded stock were deductible at their full fair market value.\textsuperscript{101} However, the Code still valued gifts of other kinds of appreciated property, including closely held stock and real estate, only at cost plus sixty percent.\textsuperscript{102} The Tax Reform Act of 1986 slightly tweaked this last provision and reduced the valuation of appreciated property given to private foundations, other than publicly traded stock, to cost.\textsuperscript{103}

Under the current Code, the section 170 deductions are available only to taxpayers who itemize their deductions.\textsuperscript{104} President Bush’s budget for fiscal year 2003 includes a proposal to allow non-itemizers to take a limited charitable contribution deduction.\textsuperscript{105}

\section*{B. Excise Taxes on Investment Income (Section 4940)}

In order to help defray the costs of the Service’s regulation of the nonprofit sector, the 1969 Act instituted a four-percent excise tax on the net investment income of private foundations as a “charge or audit fee” to “share some of the burden of paying the cost of government.”\textsuperscript{106} At the rate of four percent, the tax raised far more money than the Service actually

\begin{itemize}
\item \textsuperscript{97} See id.
\item \textsuperscript{98} See id. at 62.
\item \textsuperscript{99} See id.
\item \textsuperscript{100} See id.
\item \textsuperscript{101} See id.
\item \textsuperscript{102} See id.
\item \textsuperscript{103} See id.
\item \textsuperscript{104} See I.R.C. § 170.
\item \textsuperscript{105} See Elizabeth Schwinn, President Bush Renews Call for Charity Tax Incentives in 2003 Federal Budget, CHRON. OF PHILANTHROPY, at http://philanthropy.com/free/update/2002/02/2002020401.htm (Feb. 4, 2002). The Bush Administration’s FY2003 budget proposal would allow non-itemizers to deduct a portion of their charitable donations up to a cap of $500 for individuals or $1000 for joint filers. See id.
\item \textsuperscript{106} STAFF OF JOINT COMM. ON INT. REV. TAX., 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969 29 (1970).
used in its Exempt Organizations Department to regulate the nonprofit sector. Recognizing this, Congress reduced the excise tax rate to two percent in 1978. In 1984, Congress amended the Code again to create a two-tiered excise tax. The default rate remains at two percent, but foundations whose qualifying distributions exceed their historical average in any given year receive a favorable one-percent rate.\footnote{See I.R.C. § 4940. In 1995, 36% of private foundations paid the 1% excise tax and 64% paid the 2% excise tax. Among foundations whose assets exceeded $50 million, 47% paid 1% and 51% paid 2%. Paul Arnberger, Private Foundations and Charitable Trusts, 1995, INT. REV. SERV., STAT. OF INCOME BULL., Winter 1998-99, at 60, 67. Critics claim that this two-tiered system creates a disincentive for foundations to increase giving. See infra note 213 and accompanying text.} The excise tax has remained unchanged since 1984. Exempt organizations designated as public charities are not subject to the excise tax on investment income.

C. Prohibitions on Self-dealing (Section 4941)

The 1969 Act imposed a penalty tax of five percent on acts of self-dealing between a private foundation and certain “disqualified persons,” which include substantial contributors to the foundation, a foundation manager, an owner of more than twenty percent of a corporation that is a substantial contributor to the foundation, and certain government officials.\footnote{See I.R.C. §§ 4941, 4946.} Congress intended the tax on self-dealing to replace the subjective arm’s length standard of conduct established by the 1950 law and to deter the misuse of private foundations for non-charitable purposes.\footnote{See Edie, supra note 95, at 56; see also Williams & Moorehead, supra note 50, at 2108.} Self-dealing acts conducted between a private foundation and a disqualified person include sales, exchanges, and leases of property, loans or other extensions of credit, payment of excessive compensation, transfer to or use of foundation assets by disqualified persons, and payments to government officials.\footnote{See I.R.C. § 4941; see also Williams & Moorehead, supra note 50, at 2108-09.} In contrast, public charities are subject only to a general prohibition against “private inurement.”\footnote{See I.R.C. § 501(c)(3).} The Tax Reform Act of 1976 included some minor changes to self-dealing provisions.

D. Minimum Distribution Requirements (Section 4942)

The Revenue Act of 1950 prohibited nonprofit organizations from “unreasonably” accumulating assets.\footnote{See Edie, supra note 95, at 46.} The 1969 Act replaced this vague
standard with a requirement that private foundations pay out all of their net
investment income within one year of receipt or distribute a minimum of
six percent of the foundation’s endowment, whichever figure was
greater.\textsuperscript{113} The statute included a formula to determine the minimum
distribution amount, which could fluctuate greatly from year to year.\textsuperscript{114}
Foundations that failed to make distributions at the minimum level were
subject to a penalty tax of fifteen percent of the undistributed amount.\textsuperscript{115}

The minimum payout provision quickly became one of the most
controversial aspects of the 1969 Act. The fluctuating nature of the formula
made planning difficult for foundations, and “the combined effect of
inflation, falling stock prices, and the payout minimum was forcing a steady
erosion of foundation assets.”\textsuperscript{116} In 1973, the Commission on Private
Philanthropy and Public Needs (Filer Commission) evaluated the impact of
the new rules.\textsuperscript{117} The Filer Commission suggested that the minimum
payout requirement should be simplified to a flat five percent of assets.\textsuperscript{118}
Congress implemented the recommendation in the Tax Reform Act of 1976,
eliminating the formula and substituting a requirement that foundations pay
all adjusted net income or five percent of net assets, whichever was
greater.\textsuperscript{119}

Double-digit inflation continued to wreak havoc on foundation assets
and prompted Congress once again to address the minimum distribution
requirements in the Economic Recovery Tax Act of 1981 in which it
simplified the minimum payout to five percent of all net investment
assets.\textsuperscript{120} Changes to the Code since 1981 have not affected the minimum
distribution requirements. While public charities are not subject to the
requirements, most community foundations and for-profit charitable funds
voluntarily attempt to adhere to these limits.\textsuperscript{121}

\textsuperscript{113} See id. at 56-57.
\textsuperscript{114} See id. at 57.
\textsuperscript{115} See id.; see also Williams & Moorehead, supra note 50, at 2109.
\textsuperscript{116} Edie, supra note 95, at 59-60.
\textsuperscript{117} See id. at 60.
\textsuperscript{118} See id. supra note 55.
\textsuperscript{119} See id.
\textsuperscript{120} See id. at 61.
\textsuperscript{121} The minimum payout requirement is commonly justified because donors to private
foundations receive an immediate tax benefit, but normally society does not receive the full
benefit immediately. A recent article explains:

We rarely stop to think about the differences between direct giving to
operating charities and donations through foundations, but they are striking.
When an individual contributes $100 to a charity, the nation loses about $40 in
tax revenue, but the charity gets $100, which it uses to provide services to
E. Restrictions on Excess Business Holdings (Section 4943)

To address congressional concerns about the use of private foundations as tax shelters for family-owned businesses, the 1969 legislation prohibited private foundations with certain disqualified persons from retaining more than twenty percent of the voting stock of a corporation. 122 If an unrelated party has effective control of a corporation, a foundation and its disqualified persons may own up to thirty-five percent. 123 An excise tax of five percent enforces this restriction. 124 Congress gave foundations owning excess holdings when the law went into effect extended periods to divest, and those that obtained such holdings after 1969 had five years to divest. 125 Foundations that fail to make the required divestiture within the time permitted by law incur a penalty tax of 200%. 126 The Deficit Reduction Act of 1984 gave any foundation that acquired excess business holdings after 1969 the ability to obtain a five-year extension to divest, provided it showed good faith. 127 Public charities are not subject to similar prohibitions on excess business holdings, which may make community foundations much more attractive philanthropic vehicles for individuals or families whose source of wealth is a closely held business. 128

society. The immediate social benefit, then, is 250% of the lost tax revenue. When $100 is contributed to a foundation, the nation loses the same $40. But the immediate social benefit is only the $5.50 per year that the foundation gives away—that is, less than 14% of the forgone tax revenue.

Of course, the foundation will continue to pay out 5.5% of principal for many years to come. Even so, there is a substantial cost in holding so much money aside. At a 10% discount rate, for example, the present value of the foundation’s cumulative contributions after five years is only $21. After 100 years, it is still only $55. Compare that with the $100 contributed directly to the provider of social services in year one.

Regardless of the discount rate one chooses, the fact remains that we as a nation pay up front for deferred social benefits.

Porter & Kramer, supra note 25, at 122.

122 See I.R.C. § 4943. For example, if a disqualified person owned ten percent of the voting stock of a corporation, the foundation itself could not own more than ten percent. See Williams & Moorehead, supra note 50, at 2109; see also Edie, supra note 95, at 57.

123 See I.R.C. § 4943.

124 See Edie, supra note 95, at 57.

125 See id.

126 See I.R.C. § 4943.

127 See Edie, supra note 95, at 63.

128 Community foundations stress this particular advantage to potential donors. See CAL. CMTY. FOUND., GIVING FOR GOOD: PHILANTHROPIC TOOLS FOR ESTATE PLANNERS 10 (n.d.) (“A partnership with the California Community Foundation is a cost-effective way to maximize and target charitable involvement while minimizing tax liability.”).
F. Prohibitions on Speculative Investments (Section 4944)

The 1969 Act repealed section 504 of the Code, a provision that had the power to revoke a foundation’s tax exemption if it were engaged in speculative investments undertaken in a manner that jeopardized the exempt purpose of the foundation.129 Section 4944, which attempted to prevent the same behavior through a penalty tax of five percent of the amount involved, replaced section 504.130 Foundation managers who knowingly engage in investments that jeopardize charitable purposes are also subject to a five percent penalty tax.131 A foundation’s failure to withdraw from speculative investments can result in a second-tier tax of twenty-five percent against the foundation and an additional five percent against responsible managers.132 Some investments, such as low-interest student loans, that have a programmatic justification and are not intended to produce income are acceptable under the provision.133 The investments of public charities are not subject to similar provisions, but it is not clear from the legislative history why speculative investments would be more likely to occur or more damaging in private foundations than in public charities.134

III. THE AMERICAN NONPROFIT SECTOR: 1969 VERSUS 2002

Representative Patman’s populist attack on the perceived excesses of independent foundations heavily influenced the structure and provisions of the 1969 Act. In particular, the public perceived the excise tax as a form of punishment for elite foundations, like the Ford Foundation, that engaged in tax-exempt political activism.135 However, much of the 1969 legislation

California Community Foundation proposes several instances in which partnership with the Foundation provides advantages to donors, including helping to pass ownership of the company to children or key employees while not straining available assets and liquidity, selling the company and planning to minimize estate taxes, getting equity out of the company to provide income for a client, and creating a family philanthropic program using the assets of a client’s business. See id.

129 See Edie, supra note 95, at 57; see also Williams & Moorehead, supra note 50, at 2109.

130 See I.R.C. § 4944(a)(1).

131 See I.R.C. § 4944(a)(2).

132 See I.R.C. § 4944(b).

133 See Edie, supra note 95, at 57.

134 Perhaps the presumed accountability that accompanies the multiple sources of support of public charities explains why Congress would think they are less susceptible to speculative investments.

can also be seen as a continuation of Congress’s historic concern with the financial practices of independent foundations.\textsuperscript{136} Given the state of the foundation world in 1969, framing the concern over donor control with a private/public paradigm is understandable. In 1969, the original donors or their immediate families still controlled the vast majority of private foundations created after World War II.\textsuperscript{137} “As a practical matter, subject only to the outside chance of an IRS audit—before 1969, a very outside chance indeed—foundations’ operations commonly were carried on from year to year without the knowledge, interest, or intervention of any outside party.”\textsuperscript{138}

In contrast, public charities were independent of a single dominant donor and generally considered to be more open to public scrutiny since respected community leaders, who were independent of both each other and the charity’s most substantial contributors, comprised the boards of such charities. In short, there were a number of disinterested, independent people involved in public charities on which the public could rely to serve as watchdogs.\textsuperscript{139} First-generation private foundations lacked the oversight of such independent individuals.\textsuperscript{140}

\textsuperscript{136} See generally Williams & Moorehead, supra note 50.


\textsuperscript{139} But see Regina E. Herzlinger, Can Public Trust in Non-profits and Governments Be Restored?, HARV. BUS. REV., Mar.-Apr. 1996, at 97, 99. Herzlinger argues that nonprofits, including public charities, lack three accountability mechanisms that exist in publicly traded companies:

First, they do not have the self-interest that comes with ownership and helps to ensure that managers do not receive excessive compensation, that the business accomplishes its goals efficiently, and that risks are appropriately evaluated. Second, they often lack the competition that would force efficiency. Many are near-monopolies, such as the public schools, or serve indigent clients who cannot shop for better services. Finally, they lack the ultimate barometer of business success, the profit measure.

Id. Herzlinger suggests creating an accountability system within the Service, based on the model of the Securities and Exchange Commission. See id. at 100-07.

\textsuperscript{140} See Troyer, supra note 138, at 44. René Wormser, General Counsel of the Reece Congressional Committee, a predecessor of Representative Patman’s investigatory committee, charged that perpetual tax-exempt funds had created an elite
Congress elected to organize the restrictions contained in the 1969 legislation using the indirect private/public dynamic rather than directly basing the restrictions on amount of donor control. It did so despite its chief concern that donors who maintained too much control over their donations after their commitment to philanthropy would have an opportunity to engage in inappropriate behavior. The result is that the Code considers older private foundations, which are removed from their original donors by several generations and now controlled by independent boards, as private even though there is no donor control problem. On the other hand, donors are able to retain significant control over their gifts through donor-advised funds at community foundations even though those institutions receive treatment as public charities. Thus, even in 1969, the private/public distinction did not create categories that precisely addressed congressional concerns. The developments of the past thirty-one years, particularly the rise of community foundations and the creation of for-profit charitable funds, have made the disconnect between the intent of the Code and the reality of the modern philanthropic giving even more pronounced.

While community foundations in 1969 represented an insignificant segment of the foundation world, both in number and total assets, they have since increased by both standards. In the 1990s in particular, community foundations grew at an astounding rate. There were approximately 500 community foundations in 1995 and more than 660 in 2000. In 1999 alone, eighty-two new community foundations were established. As the number of community foundations increased dramatically in the 1990s, their assets grew as well. In 1988, twelve community foundations held at

in control of gigantic financial resources operating outside of our democratic processes, which is willing and able to shape the future of this nation and of mankind in the image of its own value concepts. An unparalleled amount of power is concentrated increasingly in the hands of an interlocking and self-perpetuating group. Unlike the power of corporate management, it is unchecked by stockholders; unlike the power of government, it is unchecked by the people.


141 Examples include the Ford Foundation, Carnegie Corporation, Lilly Endowment, and Kellogg Foundation.

142 Other public charities, such as churches and educational institutions, are also willing to host donor-advised funds.


144 See Columbus Found., supra note 19.

least $100 million in assets. Ten years later, fifty community foundations each held at least $100 million in assets, and three held more than $1 billion each.

While community foundations have benefited from a good national economy and a strong stock market, they have also profited from the Code's distinction between private foundations and public charities—a distinction that has allowed donors to community foundations to enjoy exclusive privileges among the class of donors to private foundations. This phenomenon will be discussed in more detail in Part IV of this article.

Community foundations may also attribute part of their dramatic rise to the efforts of several large private foundations, including the Kellogg Foundation's philanthropy program and the Lilly Endowment's Giving Indiana Funds for Tomorrow (GIFT) initiative. In 1990, the Lilly Endowment initiated the GIFT program to provide matching funds to new community foundations in its home state. Since the program began, the number of community foundations in Indiana grew from fewer than a dozen to more than ninety, and their assets increased from about $100 million to more than $700 million in 1999.

When compared to the size and wealth of the entire foundation world, community foundations still represent a relatively modest slice of the pie; however, their importance has increased significantly since 1969. In 1998, Americans gave more than $2.8 billion to community foundations, an increase of seventeen percent over the previous year. This figure included a number of large gifts, including a $90-million gift from the Efroymson family to endow a supporting organization of the Central Indiana Community Foundation. This gift is significant because the Efroymson family already has a private foundation, the Moriah Fund. The decision to create a supporting organization at a community foundation rather than further fund the family's own private foundation suggests that

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146 See Blum, supra note 38, at 15.
147 See id. The Cleveland Foundation, the Marin Community Foundation in California, and the New York Community Trust each held more than $1 billion each. See id.
148 See Bill Theobald, Lilly GIFT Is a Wrap for Now, INDIANAPOLIS STAR, Nov. 19, 1999, at C1. Each of Indiana's ninety-two counties now has a community foundation, and one, Lake County in northwest Indiana, has two. See id.
149 See Blum, supra note 38, at 15.
150 See Daniel Efroymson, INDIANAPOLIS STAR, Dec. 4, 1999 at A14; see also Bill Theobald, City Loses Great Giver of Money, Compassion, INDIANAPOLIS STAR, Dec. 2, 1999, at A1 ("In 1998, the Efroymson family donated $90 million to the Central Indiana Community Foundation, which includes the Indianapolis Foundation. It was the largest single gift in the foundation's history and made it one of the largest community foundations in the country.")
the Code’s preference for public charities over private foundations may have an impact on philanthropists’ choice of charitable vehicle.

The second major development in the American nonprofit sector since 1969 is the rise of for-profit charitable funds. In 2000, the three leading gift funds associated with financial services companies controlled $2.4 billion in assets from more than 23,000 donors, even though the oldest, the Fidelity Charitable Gift Fund, was then only seven years old, and the other two, the Schwab Fund for Charitable Giving and the Vanguard Charitable Endowment Program, were less than a year old.\footnote{151} At the end of fiscal year 2001, Fidelity’s Charitable Gift Fund alone controlled $2.65 billion\footnote{152} and was the second most successful public charity in terms of annual fundraising, topping the YMCA, the American Cancer Society, the American Red Cross, and Harvard University.\footnote{153} For-profit charitable funds currently appeal to a more limited audience than community foundations because they require an initial investment of $10,000 to $25,000 in cash or publicly traded securities.\footnote{154} However, since the Code treats for-profit funds like public charities, gifts are subject to more liberal levels of deductibility: fifty percent of adjusted gross income for cash donations and thirty percent for donations of stock. Community foundations and traditional public charities have expressed concern that these new for-profit charitable funds have siphoned off money that would have otherwise gone into their coffers. But the high average value of the donor-advised funds with these new for-profit entities, $130,000 for Vanguard\footnote{155} and $96,000 for Fidelity,\footnote{156} suggests that some wealthy Americans may be choosing to funnel their philanthropy through their financial services companies rather than to set up their own private foundations.

In short, the rising importance of community foundations and for-profit charitable funds, both treated as public charities under the current Code’s private/public paradigm, undermines the assumptions on which the creation of the structure rested. If Congress’s true concern in 1969 was the potential abuse of philanthropic vehicles by donors who maintained control over their gifts after receiving tax deductions, then it must reconsider the private/public distinction created to address that issue in order to accommodate both community foundations and for-profit charitable funds.

\footnote{151}{See Louis, supra note 8.}
\footnote{152}{See Fidelity Charitable Gift Fund, supra note 45.}
\footnote{153}{See Nicole Lewis & Meg Sommerfeld, Donations to the Big Groups Rose 13% in 2000, CHRON. OF PHILANTHROPY, Nov. 1, 2001, at 35.}
\footnote{154}{See Halverson, supra note 8.}
\footnote{155}{See Louis, supra note 8.}
\footnote{156}{See Fidelity Charitable Gift Fund, supra note 45.}
Since the greatest inter-generational transfer of wealth in American history is likely to occur in the next twenty years, the effects of the outdated provisions of the Code have immediate importance. The World War II generation will leave estates worth $12 trillion to $18 trillion,\footnote{See Owen Ullmann, New Wealth Will Make ‘Death Tax’ Hit Home, USA TODAY, Jan. 25, 2000, at 1A (citing a 1999 study by the Social Welfare Research Institute at Boston College. The figures refer to inflation-adjusted “1998” dollars.); cf. Dan Siegel & Jenny Yancey, You Don’t Have to Be a Millionaire to Be a Philanthropist, TENNESSEAN, Oct. 11, 1999, at 17A (referring to a smaller figure, $10 trillion over the next thirty years, without citing a source for that figure).}\footnote{See Ullmann, supra note 157.} including an estimated 2.8 million estates worth more than $1 million each.\footnote{See Robert J. Samuelson, Darling, It’ll All Be Yours Soon, NEWSWEEK, Apr. 3, 2000, at 66 (citing the same study by John Havens and Paul Schervish of the Social Welfare Research Institute at Boston College. Again, the figures refer to inflation-adjusted “1998” dollars.).} Between 2018 and 2052, baby boomers will leave estates worth between $29 trillion and $119 trillion.\footnote{The National Committee on Planned Giving points out a related issue that demands the attention of Congress: the large sums of money in Individual Retirement Accounts (IRAs) that currently incur substantial tax penalties if they are contributed to charity. In February 2000, there was more than $1 trillion in IRAs and $5 trillion in defined contribution accounts that could be rolled over into IRAs. Under current law, any IRA withdrawal is fully taxable as ordinary income, even if the withdrawal is immediately transferred to charity. There is much anecdotal evidence that wealthy Americans with IRAs would be willing to donate the assets in those accounts to charity if it were not for the unfavorable tax treatment. The assets held in IRAs represent a significant untapped source of support for the nonprofit sector, and Congress should consider relaxing the rules regarding the taxation of withdrawals for charitable purposes. See Internal Revenue Service, National Committee on Planned Giving Comments on Charitable Remainder Trust Regs., TAX NOTES TODAY (Feb. 10, 2000) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2000 TNT 28-21).} While estate taxes and transfers to children will absorb much of this wealth, past trends suggest that testators will give a significant amount to the third sector, either through direct gifts to charity or through conveyances to private foundations, community foundations, and for-profit charitable funds. This unprecedented transfer of wealth makes the issue of the tax treatment of various philanthropic vehicles timely and pressing. To the extent that the Code wishes to encourage philanthropic giving, or at least to be neutral to the ultimate recipients of those gifts, it must be cognizant of the current options available to donors and the impact of the tax structure on donors’ choices.\footnote{See Ullmann, supra note 157.}
IV. THREE PHILANTHROPIC VEHICLES: PROS AND CONS

A. Independent Foundations/Private Foundations

Individuals or families generally establish independent foundations, which the Code classifies as private foundations. Independent foundations constitute the bulk of the American foundation world. Since they make up such a large percentage of the private foundation category, the terms often are used interchangeably.

The primary benefit of forming an independent foundation is the level of control it affords donors. Individuals can retain nearly unfettered control over the management and investment of assets contributed to their foundations. Within certain parameters, donors can decide which organizations will receive contributions and when to make distributions. This control can continue long after the donor’s death. When a founder creates an independent foundation as a trust rather than a corporation, the founder can include irrevocable provisions to ensure the continuity of his or her philanthropic interests and goals. The trust form was popular earlier in the century, but it has proven to be quite rigid compared to the corporate form, which has gained popularity in recent years.

Many donors choose to give through independent foundations because they want to memorialize their families’ philanthropy and actively involve children and grandchildren. Normally, the original donor forms an independent foundation during his or her lifetime, and either the original donor or the donor’s immediate family controls the foundation for a generation or two. By the third generation, boards comprised of community

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161 Many of the wealthy in our society are strong-willed, are loathe to part with their money, and are used to being in control. Such persons are often tempted by the idea of controlling how their charitable gift is spent. Determining where a charitable contribution goes is considered by many donors to be a way of encouraging behavior that benefits society without either the contribution or the individual becoming lost in a large organizational maze.


162 There are some limits on the investment of assets in a private foundation. Section 4943 of the Code prohibits private foundations from holding too much stock from any one corporation, and section 4944 prohibits “speculative” investments. See supra notes 122-33 and accompanying text.
and business leaders usually run independent foundations, especially large ones. Perpetual independent foundations have been very successful at keeping the memory of departed philanthropists alive. Accordingly, they hold the promise of limited immortality for some wealthy Americans.

Another major benefit of independent foundations is their ability to engage in programmatic grantmaking, which allows donors to express their interests creatively by stimulating public charities to innovate. This aspect is one of the distinctive characteristics of independent foundations and has its roots in the spirit of the pioneers of professional philanthropy, Andrew Carnegie and John D. Rockefeller.

As a comparison to philanthropy through public charities reveals, a number of distinct disadvantages offset the benefits of independent foundations. Forming an independent foundation can be expensive since most donors hire institutional trustees or financial advisors to manage the assets, and many hire professional staff to evaluate grant applications and to advise with respect to distributions. Obviously, as a foundation grows larger, it requires more staff to run it effectively. The regulations and restrictions imposed by the Code also require a good deal of bookkeeping, which makes the services of an accountant necessary. An economy of scale is at work in independent foundations; therefore, if a donor’s assets are below a certain level, the costs of operating such an enterprise do not justify the benefits.

Also, the Code’s classification of independent foundations as private foundations is a disadvantage. Thus, independent foundations are subject to the one-percent or two-percent excise tax and prohibitions against self-dealing transactions, excess business holdings, and speculative investments. The various prohibitions may be inconvenient, but they are generally understood to be reasonable restrictions. The excise tax, on the other hand, can be a significant deterrent for donors contemplating their choice of philanthropic vehicle. The excise tax, justified as a “user tax,” generates an estimated $430 million each year, which is far more than the Service spends on auditing the nonprofit sector. Obviously, foundations with more modest assets, and thus more modest investment income, pay much lower taxes. Nevertheless, compared to an excise tax bill of zero for donor-advised funds in community foundations and for-profit charitable funds, the burden on private foundations is a notable disadvantage.

163 See I.R.C. §§ 4940-45; see also supra notes 106-33 and accompanying text.
164 Large foundations pay significant amounts in the excise tax each year. For example, in 1999, the Carnegie Corporation’s excise tax bill topped $2.6 million, and in 1998, the Lilly Endowment paid an additional $6 million at the higher tax level. See Reed Abelson, Foundations in Tug-of-War on Giving, Taxes, TIMES-PICAYUNE, Feb. 24, 2000, at C8.
165 For budding philanthropists with $1 million dollars or less, the annual excise tax and
Private foundations also must make annual distributions equal to five percent of net investment assets. This requirement currently does not apply to community foundations or for-profit charitable funds, although most voluntarily exceed this payout level. For donors who wish to invest assets and build a more substantial endowment, the independent foundation’s minimum payout requirement can be a significant disadvantage.

Finally, contributions to private foundations are subject to lower levels of deductibility than contributions to public charities. Donors may only deduct contributions to private foundations up to thirty percent of adjusted gross income for cash gifts and twenty percent for gifts of appreciated property. This is significant to the extent that the tax deduction for charitable contributions may encourage philanthropic giving. It may also encourage individuals interested in maximizing their tax savings to delay major gifts to private foundations until after death.

Independent foundations have two unique characteristics that distinguish them from other institutional actors in America: they control a concentrated pool of capital that is not committed to a particular cause or program, and they are not beholden to prevailing public opinion. Thus, although independent foundations, like most nonprofit organizations, serve as mechanisms of wealth redistribution from the upper classes to the general community, the combination of these two characteristics has given independent foundations the flexibility to fund risky or creative projects that lack societal or governmental support. Independent foundations are responsible for underwriting some of the most important medical breakthroughs of the twentieth century, including the development of the polio vaccine, the invention of the pap smear, and the recent creation of a potent AIDS cocktail. The Carnegie Corporation famously is responsible for jump-starting the public library movement in the United States and can also be thanked for bankrolling innovative children’s television programs,

the administrative costs related to a private foundation may encourage giving through a community foundation or for-profit charitable fund. Certainly, the advertising materials of the public charity foundations stress these advantages.

\[166\] See I.R.C. § 4942; see also supra notes 112-21 and accompanying text.

\[167\] Currently, for-profit charitable funds have a voluntary minimum payout rate for their funds in the aggregate, not for each individual fund.

\[168\] See I.R.C. § 170. The comparable rates for public charities are fifty percent for cash gifts and thirty percent for gifts of appreciated property.

such as Sesame Street.\textsuperscript{170}

Independent foundations concentrate capital in the nonprofit sector and thus are able to tackle large community projects, especially building and endowing cultural institutions, such as art museums, opera, and theatre companies, public libraries, orchestras, and parks.\textsuperscript{171} Also, they are able to supplement and to enhance government functions, most popularly in the field of education in the form of scholarships and grants to public primary and secondary schools.

\textbf{B. Community Foundations}

Like independent foundations, community foundations make grants to other charitable organizations and engage in programmatic grantmaking.\textsuperscript{172} Unlike independent foundations, however, the Code considers community foundations to be public charities because they receive donations from multiple donors. Since it frees them from the excise tax, the minimum distribution requirement, and the behavioral restrictions imposed on private foundations contained in sections 4941 and 4943 through 4945 of the Code, their status as public charities is the most significant advantage for community foundations.\textsuperscript{173}

Individuals who choose to donate to community foundations have a number of options.\textsuperscript{174} For example, donors may give to a general unrestricted fund, which allows the foundation staff a maximum amount of flexibility to respond to pressing community needs.\textsuperscript{175} Individuals may also

\begin{footnotesize}
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  \item\textsuperscript{170} See Council on Founds., \textit{supra} note 169.
  \item\textsuperscript{171} See generally Paul DiMaggio, \textit{Non-profit Organizations in the Production and Distribution of Culture, in The Non-profit Sector: A Research Handbook} 195 (Walter W. Powell ed., 1987). The focus of private foundations on the arts, private education, and other "elite" institutions has raised the criticism that private foundations do not really serve the public good. This argument is countered by substantial investment by private foundations in anti-poverty and similar work.
  \item\textsuperscript{172} See generally Norman A. Sugarman, \textit{Community Foundations, in 3 Research Papers Sponsored by the Commission on Private Philanthropy and Public Needs} 1689 (1977) (addressing several aspects of community foundations, including their operation, role in community public service, and treatment under tax laws).
  \item\textsuperscript{174} See, e.g., CAL. CMTY. FOUND., \textit{supra} note 128, at 6-9.
  \item\textsuperscript{175} See \textit{A Simple Tool for Charitable Giving, Tr. & Est.}, CHARITABLE GIVING SUPPLEMENT, June 1999, at 23, 23 (noting that unrestricted funds are perpetual funds whose interest income is used to assist the "most significant needs of the community in each year"). Examples include the California Community Foundation's "Community Needs Fund." See
\end{itemize}
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set up one of a number of types of designated funds, which allow donors to retain some control over the ultimate use of their philanthropic dollars.\(^{176}\)

The most popular kind of designated fund is the donor-advised fund.\(^{177}\) At the time of the transfer of money or property to the community foundation, donors reserve several privileges over "their" funds. Such reservations may not constitute "material restrictions or conditions," as defined by the Treasury Regulations,\(^{178}\) but in reality, individuals who set

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\(^{176}\) See A Simple Tool for Charitable Giving, supra note 175, at 23.


\(^{178}\) Donor-advised funds that contain "material restrictions or conditions" will not be treated as public charities and may implicate the tax status of the parent community foundation. The relevant statute reads:

(ii) Component part of a community trust. In order to be treated as a component part of a community trust referred to in paragraph (e)(11) of this section (rather than as a separate trust or not-for-profit corporation or association) a trust or fund:

(A) Must be created by a gift, bequest, legacy, devise, or other transfer to a community trust which is treated as a single entity under paragraph (e)(11) of this section; and

(B) May not be directly or indirectly subjected by the transferor to any material restriction or condition (within the meaning of § 1.507-2(a)(8)) with respect to the transferred assets (emphasis added).


Treasury Regulation Section 1.507-2(a)(8) sets up a test to define "material restriction or condition":

Whether or not a particular condition or restriction imposed upon a transfer of assets is "material" (within the meaning of paragraph (a)(8) of this section) must be determined from all of the facts and circumstances of the transfer. Some of the more significant facts and circumstances to be considered in making such a determination are:

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate
up donor-advised funds may exercise a great deal of informal control over the ultimate distribution of their funds.\textsuperscript{179} Normally, donor-advised funds terminate upon the death of the donor (or the donor's spouse) and remaining assets are transferred into the community foundation's unrestricted fund. Some foundations allow a donor's child to take over as the fund's adviser after the original donor's death. Donor-advised funds are growing in popularity because they mimic the control and familial involvement of independent foundations while avoiding the restrictions of private foundations and the hassles of administering an independent foundation. Donors may deduct gifts to donor-advised funds immediately but may defer ultimate distribution for many years. Thus, a donor can make a large gift to a donor-advised fund in a high-income year, maximizing deductibility, and then spread out the philanthropy for the rest of his or her life.

Several other types of designated funds at community foundations allow donors to have limited control over the ultimate recipients of their

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\item authority and control over such assets, and the income derived therefrom;
\item and
\item (D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.
\item (ii) Independent governing body. As provided in paragraph (a)(8)(i)(D) of this section, one of the more significant facts and circumstances to be considered in making the determination whether a particular condition or restriction imposed upon a transfer of assets is "material" within the meaning of paragraph (a)(8) of this section is whether, and the extent to which, the governing body is organized and operated so as to be independent from the transferor. In turn, the determination as to such factor must be determined from all of the facts and circumstances. Some of the more significant facts and circumstances to be considered in making such a determination are:
\item (A) Whether, and to what extent, members of the governing body are comprised of persons selected by the transferor private foundation or disqualified persons with respect thereto, or are themselves such disqualified persons;
\item (B) Whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and
\item (C) How long a period of time each member of the governing body may serve as such.
\end{itemize}


\textsuperscript{179} One scholar summed up the danger: "Combine a strong-willed donor with a public charity that tries to please its major benefactors and the result often is a gift with 'strings attached.'" McGown, \textit{supra} note 161, at 279.
philanthropy, including field-of-interest funds, scholarship funds, and restricted funds. In each case, the donor broadly designates at the time of the gift where he or she wishes the money to go, and the community foundation maintains flexibility for grantmaking within those predetermined categories.\(^{180}\)

Finally, many community foundations allow large donors to create supporting organizations, which have many of the characteristics of private foundations but have public charity status due to their relationships to community foundations.\(^{181}\) To qualify as a public charity under the Code, supporting organizations must carry out the purpose of and be controlled by the community foundation (or other public charity that is being supported). In practical terms, an independent board made up of representatives from the donor’s family and the community foundation manages a supporting organization. The foundation selects the majority of board members to maintain the requisite control. The foundation also provides administrative support, including liability insurance, financial reports, annual audits, and preparation of tax returns. The supporting organization’s assets normally either may be pooled with the community foundation’s endowment or managed separately. The ability to separate assets is particularly useful to donors who contribute assets, such as real estate or closely-held business interests. Supporting organizations are attractive options for those donors whose wealth consists of a closely-held business or publicly-held corporation because private foundation rules prohibit excessive business

\(^{180}\) See A Simple Tool for Charitable Giving, supra note 175, at 23. A “field of interest” fund is a permanent endowment that generates income for any legitimate charitable interest, such as health care for the elderly or day care for underprivileged children. The community foundation has discretion to use the fund income for any qualified nonprofit that fulfills the charitable intent of the field of interest fund. A “donor designated fund” is a perpetual endowment that generates income for a particular charity or charities designated by the donor. See id.

\(^{181}\) The parameters of supporting organizations are set out in section 509(a)(3) of the Code. A supporting organization is defined by the statute as an organization which

(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2),

(B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and

(C) is not controlled directly or indirectly by one or more disqualified persons . . . .

holdings.  

Community foundations have gained popularity in recent years because they allow people with moderate wealth who do not have the assets to start an independent foundation to engage in planned philanthropy. Most community foundations allow the creation of donor-advised funds with an initial investment of $10,000 or less, and gifts to designated and unrestricted funds can be quite modest. Community foundations allow philanthropists of moderate wealth to pool their assets and to take advantage of the resulting economies of scale.

Community foundations can have a very positive impact on the geographic areas they serve. Like independent foundations, they facilitate the transfer of wealth to the community, supplement government functions, and concentrate capital for large projects. Unlike independent foundations, community foundations also can allow the entire community to participate in philanthropy and grantmaking.

Despite the obvious benefits, there are a few disadvantages for donors who choose to utilize community foundations. By their very nature, community foundations focus their grantmaking in a particular geographic area. Normally, community foundations are organized to serve a city or county, but in less populated areas, they may cover a larger area. Although concentration on a single community is a hallmark of the community foundation, this characteristic may not be attractive for donors without strong ties to a single community, particularly in an era of mobility.

Additionally, while community foundations are flexible organizations, they normally lack the staffs to facilitate the kind of programmatic grantmaking that distinguishes independent foundations. Instead, they are generally oriented towards channeling gifts to local public charities. Larger, more established community foundations may engage in limited grantmaking, especially in the area of education.

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182 The California Community Foundation, which serves the Los Angeles area, calls its supporting organization option the “Chartered Family Foundation,” and its promotional materials stress the similarities in function between supporting organizations and private foundations without the negative tax consequences. Above a chart demonstrating the differences between private family foundations, the chartered family foundation, and donor-advised funds, the brochure states: “We’re the philanthropic alternative for clients interested in creating their own private foundations.” CAL. CMTY. FOUND., supra note 33, at 9.

183 While this is not a legal requirement, the community foundation model has evolved in this manner. But see discussion supra note 37.

184 For example, the South Dakota Community Foundation, a community foundation with a permanent endowment valued at over $30 million, focuses on the entire state of South Dakota. See SD Cmt. Found., SDCF History and Mission, at http://www.sdcommunityfoundation.org/aboutus/body.htm (last visited Apr. 11, 2002).
The final disadvantage concerns whether community foundations serve the areas in greatest need of assistance. Since community foundations leverage local wealth to benefit a particular community, the focused nature of community foundations indicates that communities lacking wealth do not stand to benefit from this model of philanthropy. Although the efforts of the Lilly Endowment and Kellogg Foundation encouraged community foundations in less populated counties throughout Indiana and Michigan, community foundations originated in urban areas and are still primarily an urban phenomenon.\textsuperscript{185} A geographic imbalance of grantmaking institutions, including community foundations, exists in the United States, and those areas that need philanthropic dollars the most have the least access.\textsuperscript{186} Community foundations are not designed to redirect assets toward other geographic areas, no matter how desperate the need.

\textbf{C. For-Profit Charitable Funds}

The new for-profit charitable funds, such as the one established by Fidelity Investments in 1992, primarily utilize the donor-advised fund model invented by community foundations. In fact, these for-profit charitable funds are basically holding organizations for donor-advised funds created by clients of the financial services companies.\textsuperscript{187}

\textsuperscript{185} See A Simple Tool for Charitable Giving, supra note 175, at 23 (pointing out that “[d]ue to the generous matching gift support from Lilly Endowment Inc. every county in Indiana is served by a community foundation”); see also supra notes 143-47 and accompanying text.

\textsuperscript{186} See Pablo Eisenberg, Redrawing the Map of Philanthropy, CHRON. OF PHILANTHROPY, Sept. 9, 1999, at 43 (explaining that seventy-one percent of American foundations are located in states in the Northeast, Midwest, and on the West Coast). Furthermore, there is no sign that this imbalance is changing:

As other, new high-tech millionaires in Silicon Valley and elsewhere pursue their philanthropic interests – and as the older, established foundations receive new infusions of money and reap the benefits of the soaring stock market – the greatest expansion of foundation assets and foundation giving will undoubtedly take place in the three already dominant regions. Simply put, that is where the big money is.

\textit{Id.}

\textsuperscript{187} Although the Service has granted public charity status to the major for-profit charitable funds, the Service attempted to revoke the favorable tax status of two early prototypes, National Foundation, Inc. (NFI) and The Fund for Anonymous Gifts (Fund), with different results. After the Service rejected NFI’s Application for Recognition as a tax-exempt organization in 1986, NFI sought a declaratory judgment in United States Claims Court that it was a tax-exempt organization under section 501(c)(3). See Nat’l Found., Inc. v. United States, 13 Ct. Cl. 486, 488 (1987). NFI operates similarly to for-profit charitable funds. The Service objected to this structure, portraying it as a “federation of individual
From a donor’s point of view, the donor-advised funds at a for-profit charitable fund are more flexible than those offered by community foundations. Both types of charitable organizations provide donors with many of the benefits of the independent foundation model without the unfavorable private foundation tax status or administrative hassles. However, while donors can recommend grant recipients within the community foundation’s geographic area only, individuals who have contributed to donor-advised funds at for-profit charitable funds may designate any public charity in the United States as a grant recipient.

Treasury Regulations forbid donor-advised funds from containing “material restrictions or conditions,” but they do not require charitable organizations to review actively donor recommendations by any particular criteria. The structure of these regulations allows for-profit charitable funds, such as Fidelity’s Charitable Gift Fund, to utilize a one page “Grant Recommendation” form that simply asks for the recipient charitable organization’s legal name, address, and federal tax identification number (if available). The Grant Recommendation Guidelines accompanying the form include the following advice to the donor: “Your recommendation is

customers serviced by a central organization.”” Id. at 491-92. Based on NFI’s 2.5% administrative fee, the Service concluded that NFI was “nothing more than an aggregate of separate organizations.” Id. at 493. The court rejected the Service’s argument and ruled that NFI was a section 501(c)(3) organization. See id. at 496.

A decade later, the Service challenged the tax status of the Fund with a bit more success. See Fund for Anonymous Gifts v. Internal Revenue Serv., 97-2 U.S.T.C. (CCH) ¶ 50,710 (D.D.C. 1997), vacated and remanded in part by, 194 F.3d 173 (D.C. Cir. 1999). The Fund’s structure also is similar to for-profit charitable funds, although it is not affiliated with any particular financial services company. The District Court for the District of Columbia found that the Fund was not a section 501(c)(3) organization because it lacked a charitable purpose. See id.; see also Justice Department Briefs, Donor-Advised Fund Not Entitled to Exemption, IRS Argues, TAX NOTES TODAY (Apr. 2, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 63-25).

In essence, the Fund’s application was denied because the materials submitted by the Fund indicated that the Fund would not take complete control over the funds donated, but, instead, would follow the directions of the donors as to the investment of the “donated” funds and as to the ultimate distribution of those funds and the income earned thereon.

Id. The Fund’s legal difficulties were eventually resolved in its favor after it amended its charter to incorporate a charitable purpose. For a detailed analysis of the argument that for-profit charitable funds should not be entitled to section 501(c)(3) status because they lack a true charitable purpose, see generally Albert R. Rodriguez et al., The Tax-Exempt Status of Commercially Sponsored Donor-Advised Funds, 17 EXEMPT ORG. TAX REV. 95 (1997).

See supra note 178.

subject to review and approval by the Gift Fund. Upon receipt of the recommendation please allow up to ten business days to approve and process the grant."^{190} However, none of the Charitable Gift Fund's voluminous promotional materials^{191} include any information regarding review procedures or criteria. Apparently, any verifiable public charity will be approved for a grant.^{192} However, the Charitable Gift Fund is careful to warn donors that it will not approve grants to private foundations or foreign charities. In addition, the Charitable Gift Fund cautions:

Grants from your donor-advised fund may not be used for any pre-existing pledge or benefit, such as school tuition, scholarships sent directly to individuals, dues, membership fees, benefit tickets, or goods bought at charitable auctions. Nor may grants be used for lobbying, political contributions, or to support political campaign activities. Please note that if any part of your contribution pays for goods, services, or benefits a specific person, the Gift Fund will reject your recommendation.^{193}

Beyond these restrictions, individuals who contribute to donor-advised funds at for-profit charitable funds appear to have great control in selecting the beneficiaries of their philanthropy.

In addition to recommending grant recipients, donors may exercise

\(^{190}\text{Id.}\)

\(^{191}\text{An additional concern regarding for-profit charitable funds is their costly (and effective) marketing campaign. "Can you imagine what would happen if we focused on marketing the way Fidelity does?" asks Ani Hurwitz, spokeswoman for the New York Community Trust. "There would be a hue and a cry: "Charity spends$2 million on advertising!"." Peter Keating & Beverly Goodman, The New Business of Giving, MONEY, YEAR-END SUPPLEMENT, 1998, at 92, 97.}\)

\(^{192}\text{See Charitable Gift Fund, Frequently Asked Questions, at http://www.charitabledgift.org/faqs/index.shtml (last visited June 2, 2002) ("In general, recipient organizations must be qualified as charitable under Section 501(c)(3) of the [Code] and must be public charities under Section 509(a)(1). Grant recommendations are subject to Gift Fund Trust approval. You will be notified if an organization you recommend to receive a grant is not approved."); see also Gene Steuerle, Charitable Endowments, Advised Funds & the Mutual Fund Industry - Part Two: Reconsidering the Foundation Rules, TAX NOTES TODAY (Jan. 11, 1999) (LEXIS, FEDTAX lib., TNT file, elec. cit., 1999 TNT 6-61) (pointing out that for-profit charitable funds generally only check to see if a recipient organization is a section 501(c)(3) organization and that there is "little investigation of the worthiness" of the organization).}\)

\(^{193}\text{Charitable Gift Fund, supra note 192. While these statements simply restate the prohibition on excess benefit transactions found in section 4958, the Charitable Gift Fund highlights the legal restrictions on donations because, in its early days, it experienced some difficulties with donors who tried to exploit the model. See I.R.C. § 4958.}\)
limited control over how their contributions are invested.\textsuperscript{194} The Charitable Gift Fund allows donors to choose among four investment pools that invest in Fidelity mutual funds.\textsuperscript{195}

Although donor-advised funds are the most popular vehicles at for-profit charitable funds, pooled income funds are also available. These funds are designed to provide income to the donor during her lifetime, with the remainder going to charity. A minimum initial contribution of $20,000 is required, and additional contributions must be at least $5000 each.\textsuperscript{196}

For-profit charitable funds charge an administrative fee based on the asset value in each individual fund. The Charitable Gift Fund, for example, charges an annual fee of one percent.\textsuperscript{197} Although community foundations charge similar fees for managing donor-advised funds, they offer more services, including education and guidance to donors that help them match their contributions to community needs. In contrast, for-profit charitable

\textsuperscript{194} Conversely, individuals who create donor-advised funds at community foundations or other public charities that offer them, such as private universities, do not generally have any choice over how their funds are invested.

\textsuperscript{195} The four pools are: the growth pool (which seeks long-term capital growth), the equity-income pool (which seeks a "reasonable" total return), the interest-income pool (which seeks a high level of income), and the money market pool (which seeks preservation of principal). \textit{See} Charitable Gift Fund, \textit{Learn More About Our Investment Pools}, at http://www.charitablegift.org/daf/04_t3_bdonor_pools.shtml (last visited May 22, 2002).

\textsuperscript{196} \textit{See} Charitable Gift Fund, \textit{How the Pooled Income Fund Works}, at http://www.charitablegift.org/daf/04_t2_bdonor_howpifworks.shtml (last visited May 22, 2002). These pooled income funds are very similar to those offered by a number of public charities, especially religious organizations and secondary educational institutions. A pooled income fund has been defined as:

\begin{quote}

a trust maintained by a charitable organization described in Section 170(b)(1)(A)(i)-(vi), such as Harvard, to which several donors make gifts, retaining income interests for themselves or their designated beneficiaries and naming Harvard as the remainder beneficiary. The pooled income fund (the "PIF") is governed by Section 642(c)(5) and functions very much like a mutual fund for the commingling and investment of retained life-income gifts. All the income earned by the PIF is paid out on a current basis to the income beneficiaries. On the death of the income beneficiary of a particular gift, or the last beneficiary if the interest runs for the life of more than one beneficiary, the corpus attributable to that gift is severed from the fund and transferred to or for the use of Harvard.
\end{quote}


\textsuperscript{197} \textit{See} Charitable Gift Fund, \textit{supra} note 192. Management and administrative fees charged by for-profit charitable funds currently range from 0.65% to 1%. \textit{See} Keating \& Goodman, \textit{supra} note 191, at 99.
funds employ few experts in philanthropy and offer little advice. While the fees themselves may not be improper, there is a general concern regarding the interests of financial services companies in setting up these charitable funds in the first place—a concern underscored by the for-profit designation given to these funds. Donors have a choice between investment pools, but their choices are limited to pools managed by the fund’s parent financial services company. All of the Charitable Gift Fund’s investments, for example, are in Fidelity Investments mutual funds. Within the normal course of business, Fidelity takes a portion of the profits from its mutual funds as a fee; consequently, in addition to the one-percent annual fee charged by the Charitable Gift Fund, Fidelity profits from every dollar contributed to the fund. This mixture of philanthropy and profit, combined with the remarkable amount of control given to individuals who create donor-advised funds, raises concerns about for-profit charitable funds.

V. PROPOSALS FOR REFORM

A. Recent Proposals for Reform

The Clinton Administration’s Fiscal Year 2001 Budget contained the most significant recent legislative initiatives relevant to this article. The Clinton Administration proposed to simplify the private foundation excise tax, to increase percentage limits on donations of appreciated property, and to clarify the public charity status of donor-advised funds, particularly for-profit donor-advised funds. None of these proposals became law. The newest proposal for reform, the Bush Administration’s Fiscal Year 2003 Budget, contains only one provision relevant to the concerns raised in this article: a proposal to simplify and lower the excise tax on private foundations. The Bush Administration proposal does not address the

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198 See Keating & Goodman, supra note 191, at 97; see also Steuerle, supra note 192.

199 Critics charge that, at a fundamental level, these for-profit charitable funds lack a charitable purpose and are not valid tax-exempt organizations under section 501(c)(3). See Rodriguez et al., supra note 187, for a detailed explanation of this argument.


201 See Schwinn, supra note 105. It is also interesting to note that the Bush Administration has proposed to allow individuals who do not itemize their deductions, estimated by the White House to be about seventy percent of American taxpayers, to take a limited deduction for charitable contributions up to a cap of $500 for individuals and $1000 for joint filers. See id. This proposal also addresses what some observers perceive as the
murky status of donor-advised funds.

Under current law, private foundations are subject to a two-percent excise tax on net investment income.\textsuperscript{202} This excise tax rate drops to one percent in years when a foundation's qualifying distributions exceed its historical average.\textsuperscript{203} President Bush's budget proposal would replace this two-tiered approach with a flat excise tax of one percent on the net investment income of private foundations.\textsuperscript{204} The Bush proposal is attractive because it disposes of an unduly complicated two-tiered system of excise taxation that has not appeared to realize its intended effects.\textsuperscript{205} This proposal should also increase distributions to charity because a foundation must distribute to charities an amount equal to five percent of assets less the excise tax to satisfy the minimum distribution test.\textsuperscript{206}

While the Bush Administration's proposed change would be an improvement over the current, inefficient two-tiered excise tax, I propose taking a more fundamental look at the excise tax and its relationship to the independent sector.

\textbf{B. A Call to Restructure the Paradigm to Address Donor Control}

This article has discussed a number of places that the Code, largely determined by the 1969 Act, fails to connect with the reality of the nonprofit sector in 2002. I propose two changes to the Code that would reconcile the law with the concerns facing the nonprofit sector. First, I propose to eliminate the private/public distinction and replace it with categories determined by the amount of control a donor retains over his contribution. Second, I propose to reconfigure the excise tax on private foundations by imposing it on all section 501(c)(3) organizations and tailoring it to the amount the Service actually spends to audit the nonprofit sector.

The organizing principle of the current Code is the private/public

\textsuperscript{202} See I.R.C. § 4940.
\textsuperscript{203} See I.R.C. § 4940(e).
\textsuperscript{204} See Schwinn, supra note 105.
\textsuperscript{206} Approximately one-third of private foundations currently pay the one percent tax and two-thirds pay two percent. See supra note 107.
distinction. Although it may have acted as a legitimate proxy for donor control in 1969, this paradigm is inconsistent with current concerns about the nonprofit sector and reflects outdated assumptions about the benefits and dangers of private foundations and public charities. The result of this inexact match is a regime that creates incentives for donors to invest in public charities that have the flexibility of private foundations but lack the negative tax consequences. The growth of donor-advised funds at community foundations and for-profit charitable funds has changed fundamentally the nature of the nonprofit sector. Accordingly, the Code, which was aligned to reality in 1969, should be reconfigured to deal with the nonprofit world as it exists in 2002.

Congress adopted the private/public distinction to deal with the problem of wealthy individuals misusing independent foundations to avoid taxes without actually engaging in philanthropy. Organizations that have multiple sources of support, public charities, were regarded as more resistant to corruption. Therefore, prohibitions against self-dealing, speculative investments, and excessive business holdings did not apply to them. The private/public distinction, however, masks the real difference between independent foundations and so-called public charities in 1969: the amount of control the donor retained over her charitable gift. Congress adopted the private/public distinction as shorthand for donor control. However, the emergence of donor-advised funds at community foundations and for-profit charitable funds, both classified as public charities, undermines the prevailing paradigm. Individuals who establish donor-advised funds have control of the timing of their gifts and the ultimate beneficiaries, and, in some cases, they are able to choose how to invest their contributions. These privileges represent some of the characteristics of independent foundations that concerned Congress in 1969.

To respond to the changes in the philanthropic sector, Congress should revise the Code to replace the private/public paradigm with a focus on donor control. Legislators should eliminate the private/public distinction,

\[207\] Current rules also discourage donors from endowing their private foundations with large gifts of publicly traded stock. Consider, for example, the experience of Pierre Omidyar, the founder of eBay and the creator of the Omidyar Foundation. See Quentin Hardy, *The Radical Philanthropist*, FORBES, May 1, 2000, at 114. At the time the article was published, Mr. Omidyar’s net worth was approximately $6.6 billion and he planned to give nearly all of it away. By the end of the year 2000, the Omidyar Foundation was expected to hold assets of $100 million. Mr. Omidyar planned to turn over all but one percent of his net worth by the year 2020, when he will be fifty-two. However, he felt the need to delay his philanthropy because the bulk of his wealth was in eBay stock (he owned twenty-eight percent of the company) and if he transferred that stock to his foundation, it would have to sell many of the shares within five years. Mr. Omidyar was worried that this sell-off would depress the price of eBay’s stock, harming both stockholders and the company itself.
and establish categories that hinge on the amount of control the donor retains over her charitable gift. There are many aspects of donor control, including choice of donees, timing of distribution, and investment discretion. There are certainly legitimate reasons for a donor’s desire to maintain control in each of these areas, just as there are justifications for public charities allowing them to keep such control. The Code would have to answer one final question: at what point is the donor-advised fund or similar vehicle controlled more by the donor than by the charity?

The cases at the margins are the easiest to address. As the promotional materials make clear, the donor-advised funds at for-profit charitable funds have turned the prohibition on “material restrictions and conditions” into a fiction. Donors have nearly unfettered control over choice of donees and timing of distributions. They are even allowed to designate how their funds should be invested. At present, investment discretion is limited to a few funds, but it is likely that as these funds grow they will give their donors more investment options. None of this donor choice is necessarily bad, nor is it inconsistent with societal attitudes towards philanthropy. However, the issue concerns whether these funds more closely resemble a check written to the American Red Cross or the endowment of a private foundation. In my opinion, donor-advised funds have much more in common with private foundations than with ordinary gifts to public charities. Therefore, to the extent the Code wishes to distinguish between section 501(c)(3) organizations based on a fear of entities in which the donor retains control over her gift, it should treat donor-advised funds at for-profit charitable funds as private foundations.

Another entity at the margin is the supporting organization. Although the Code specifically designates supporting organizations as public charities, this appears fundamentally to conflict with the private/public distinction, as well as my proposed paradigm based on donor control. Supporting organizations essentially function as private foundations—the board retains control over choice of donees, timing of distributions, and investment discretion. The only difference is that supporting organizations must be organized for the benefit of and controlled by a public charity. However, donors may use a supporting organization to give to section 501(c)(3) charities that the supporting organization was not organized to benefit. In addition, public charities have every incentive to please large donors and to attract new supporting organizations. Legally, the public charity may retain control, but such control may be only an illusion.

208 This is likely because the for-profit charitable funds are associated with financial services companies that profit by investing donors’ funds. As more of these “charitable” funds come into the market, they likely will feel pressure to give their donors more options.
An especially troubling aspect of supporting organizations is their ability to own closely-held business interests, a feature stressed by community foundations and other public charities interested in attracting new supporting organizations. If Congress fears that donors who create tax-exempt funds and endow them with closely-held business interests would exploit those arrangements, it should apply the same restrictions to both supporting organizations and private foundations.

In contrast to donor-advised funds at for-profit charitable funds and supporting organizations at community foundations, donor-advised funds at community foundations appear to allow donors to retain less control. Community foundations neither give donors investment discretion, an important safeguard that negates congressional concern about self-dealing and excess business holdings, nor allow the donation of closely-held business interests. Donors do control the timing of distributions and have limited choice over donees. Donor-advised funds at community foundations permit donors less control over donees because the community in question circumscribes such control. While supporting organizations at community foundations may make gifts outside of the community, donor-advised funds normally cannot. Given the expertise of community foundation staffs in their particular communities, it is likely that they will veto suggested donations to questionable charities, a safeguard which does not exist in for-profit charitable funds. These factors distinguish donor-advised funds at community foundations from supporting organizations at community foundations and donor-advised funds at for-profit charitable funds. Thus, donor-advised funds at community foundations should retain their designation as public charities and not have to pay a higher level of tax.

The donor control paradigm, however, will not affect only these new entities. It also will divide the world of private foundations. When we talk about “private foundations,” we really are describing at least two types of organizations. The first comprises the large, established independent foundations whose names immediately come to mind (e.g., Kellogg, Lilly, Ford, Carnegie). By virtue of their sizes and ages, these foundations are no longer intimate foundations designed to involve an extended family in philanthropy. Instead, they are controlled by independent boards and have national and international missions. Although they fail the public support test, it is my contention that these foundations are fundamentally public in mission and in activity. There is no donor control problem because the donors are long dead. Whatever vulnerability these organizations have to abuse, it more closely resembles the challenges faced by large, established public charities, such as Harvard University, the American Red Cross, and the United Way, than those associated with newer, independent foundations.
controlled by the original donor or her family. I would classify these foundations, which are independent of donor control, as public charities.

The second type of independent foundation represents the vast majority of the current category of private foundations: corporate and family foundations in which the donor or her family is involved. This is the model that was subject to so many abuses in the 1950s and 1960s—the “tax dodges for the rich” that undermined public confidence in the entire philanthropic community. Although most are formed with benevolent intentions, the model itself is subject to abuse and should be subject to the restrictions on self-dealing, excess business holdings, speculative investments, and closely-held business interests. Over time, as the original donors die and the boards become controlled by independent parties rather than family or friends of the donor, thus becoming more like public charities, these foundations can transition into a lower level of scrutiny.\(^{209}\)

The features of each of these entities again highlight the breakdown of the private/public distinction and the need for a new paradigm based on donor control. The new structure would create two categories. The first would include four nonprofit entities: traditional public charities; broad, publicly-supported organizations; truly independent foundations; and donor-advised funds at community foundations. The Code would treat this category like public charities. The second category would include first- and second-generation family foundations, corporate foundations, donor-advised funds at for-profit charitable organizations, and supporting organizations. Rules regarding self-dealing, excess business holdings, speculative investments, and closely held business interests should be applied to the second category of funds under donor control.

The treatment of the prohibition on “material restrictions and conditions” demonstrates the difficulty in constructing a statute that makes distinctions based on donor control. Such donor-advised funds can fulfill the restriction easily on paper, but they can also circumvent it easily in reality. A fundamental reconfiguration of the Code is necessary, but Congress must draft the legislation carefully in order to be successful and must reevaluate the Code’s provisions periodically so that, as new models emerge in the philanthropic world, they do not render it ineffective and outdated as donor-advised funds and supporting organizations have done to the Code of 1969.

\(^{209}\) A legal mechanism should be available for living donors to establish an independent foundation and sever enough control for it to qualify immediately as a public charity. Regulations should address the selection of board members and other control mechanisms.
C. Reconfigure the Excise Tax on Private Foundations

The excise tax on private foundations is inconsistent with the goals of promoting philanthropy and exempting charity from the income tax.\textsuperscript{210} The excise tax on private foundations, no matter how justified, is a tax on the investment income of charities.\textsuperscript{211} Congress has asserted it designed the tax as a “user fee” to subsidize the costs of regulating the nonprofit sector through annual audits.\textsuperscript{212} Despite these arguments, the structure of the tax raises questions. If it honestly were intended as a “user fee” rather than a penalty, why put the burden of paying for regulation of the entire nonprofit sector only on private foundations? Why is there no excise tax on other tax-exempt organizations that are also subject to audit? Why is the excise tax tied to the net investment income of private foundations, a figure that has no relationship to the costs of auditing the nonprofit sector?

Proponents of the tax may argue that the current two-tiered structure of the excise tax encourages foundations to increase distributions. The data undermine this argument.\textsuperscript{213} In reality, the two-tiered excise tax can create

\textsuperscript{210} Some observers argue that the government is not collecting enough taxes from private foundations. See, e.g., Nelson W. Aldrich, Jr., The Gift Exchange, WORTH, Nov. 1999, at 89, 93 (arguing that the ratio between tax dollars forgone and foundation dollars distributed is inefficient, that private foundations do not effect enough social good to justify the tax subsidy, and that one way of fixing this disparity is by raising the excise tax on private foundations); Stephen G. Greene, Two Publications Question Foundation Benefits, CHRON. OF PHILANTHROPY, Nov. 4, 1999, at 70 (summarizing the Aldrich article and a similar article by Michael E. Porter and Mark R. Kramer, cited supra note 25).

\textsuperscript{211} Many in the foundation community argue strongly against the excise tax:

In many ways, this excise tax violates most standards of efficiency and equity and can only be understood as a penalty developed historically against the past abuses, real or perceived, of foundations. IRS officials, however, have given foundations high marks recently and have indicated that private foundations are less likely to be an area of the charitable sector requiring enforcement resources.

While the excise tax is not huge, it is a nuisance, especially for smaller foundations. It violates standards of simplicity of taxation, which call for limits on the number of taxes imposed by the state. Its particular design creates all sorts of havoc with filing and other requirements.

Steuerle, supra note 192.

\textsuperscript{212} But see id. (arguing that the money collected by the excise tax has always been in excess of the amount spent by the Service to monitor the nonprofit organizations. “Moreover, this money was never dedicated to the administrative function of the IRS’s Employee Plans/Exempt Organizations operation but was instead transferred to general revenues. The recent IRS restructuring formally delinks this source of funding from the EP/EO function.”).

\textsuperscript{213} See id. (referring to study by Steuerle and Martin Sullivan demonstrating that “the current payout rule actually discourages paying out larger percentages of endowment in any
a disincentive for foundations to increase substantially charitable distributions since they are rewarded only for increasing the qualifying distributions in the present year over their average. Since only incremental increases in payout rates can allow a foundation to receive the one-percent rate, foundations interested in manipulating payout rates to avoid the extra excise tax certainly can do so under the present structure of the law. Moreover, the two-tiered structure does not appear to have resulted in increased payout rates among private foundations. In fact, in the first half of the 1990s, median payout rates either remained stagnant or actually declined.\(^{214}\) The median payout rate of private foundations with assets over $50 million was 5.0% or 5.1% each year from 1991 to 1995.\(^{215}\) For those foundations with assets between $10 million and $50 million, the median payout rate actually declined from 5.4% in 1990 to 5.1% in 1995.\(^{216}\) The median payout rate for small foundations with assets between $100,000 and $1 million dramatically declined from 6.7% in 1990 to 5.5% in 1995.\(^{217}\)

Even with the adjustments made in 1978 and 1984, the excise tax on private foundations is an imperfect means of either encouraging increased payout rates or raising the funds necessary to regulate the nonprofit sector. At the current two-tiered rates of two percent and one percent, the excise tax still raises far more money than the Service spends to audit nonprofit organizations.\(^{218}\) The excise tax also creates an incentive for individuals to create donor-advised funds at community foundations or for-profit charitable funds. This choice is not without societal consequences. Although donor-advised funds have advantages, including encouraging

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year because one consequence is a higher – yes, a higher – tax in future years”). A proposal to eliminate the two-tiered foundation excise tax elicited a favorable response from Janne Gallagher of the Council on Foundations:

“It would mean tremendous simplification for foundations,” [Gallagher] said. “It means that they could increase their payout when they’ve had a particularly good year without being locked into a situation where they have to pay a 2 percent tax if, for some reason, they don’t continue to exceed that amount.” The two-tier tax, she said, has “a built-in disincentive for people to increase their giving because it effectively results in their having to pay higher taxes. So I think eliminating that in favor of a straight, flat tax is a significant improvement.”

Stokeld, supra note 205.

\(^{214}\) See Arnberger, supra note 107, at 73.

\(^{215}\) See id.

\(^{216}\) See id.

\(^{217}\) See id.

\(^{218}\) “In 1999 the excise tax raised $499-million, approximately eight times the amount that the IRS spent on supervising non-profit groups.” Pablo Eisenberg, How to Help the IRS Improve Charity Oversight, CHRON. OF PHILANTHROPY, Oct. 18, 2001, at 34.
philanthropy among those of modest wealth, they also have limitations that undermine the notion that the Code should encourage these "public charities" at the expense of private foundations. In short, the excise tax discourages foundations from substantially increasing payout rates, is contrary to the notion that charity should be exempt from income tax, and may have the effect of funneling donors away from one type of philanthropy toward others for no discernable policy reasons. Although many of the changes in the 1969 legislation were legitimate regulations, the excise tax is simply an outdated relic of a populist vendetta against private foundations that Congress once perceived to be bastions of eastern elitism. Congress should either eliminate the excise tax entirely or reconfigure the tax so that it applies to all section 501(c)(3) organizations and reflects the actual amount that the Service spends to audit the nonprofit sector.

VI. CONCLUSION

Philanthropy is an important part of American life. Tax-exempt organizations enrich our lives, conduct valuable research, and create and maintain vital community institutions and services. Congress has recognized the unique significance of philanthropy in America and has sought to strengthen it through a tax deduction for charitable contributions and tax-exemption for certain organizations. It is a curious accident of history that the Code regulates the nonprofit sector, but the result is that the structure of the Code creates incentives that impact philanthropic giving. Therefore, it is crucial that the Code accurately and consistently reflects the structure of the nonprofit sector. The 1969 Code does neither.

The private/public distinction, a more or less accurate proxy for donor control in 1969, is anachronistic in the year 2002 and is ill equipped to deal with the rising importance of community foundations and for-profit charitable funds. A new paradigm is necessary to address new entities, especially donor-advised funds and supporting organizations. Congress should discard the dubious distinction between private foundations and public charities and replace it with a paradigm based on donor control.