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# The Tax Law of Private Foundations

2022 Cumulative Supplement

*Fifth Edition*

**Shane T. Hamilton,  
Bruce R. Hopkins**

**WILEY**



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**Shane T. Hamilton,**  
**Bruce R. Hopkins**

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# Preface

This is the fourth supplement to accompany *The Tax Law of Private Foundations, Fifth Edition*. The supplement covers events occurring from the middle of 2018 (where the main volume ended) through the middle of 2022.

Much of the law developments that have occurred during the period reflected in this supplement concern the self-dealing rules, with emphasis on the law concerning indirect self-dealing. The book's treatment of this area of private foundation law has been rewritten and expanded. Particular attention is accorded the estate administration exception, in part because of two recent significant IRS private letter rulings on the point, plus a ruling on the matter of a foundation's expectancy.

Private foundation law is not frequently the subject of court opinions. One court case emerged during the covered period: the *Dieringer* case. Framed as an estate tax charitable deduction valuation case, the set of facts really is a case study in indirect self-dealing. The case is treated from that perspective in this supplement.

Other interesting private letter rulings during the period include aspects of the mandatory payout rule, the law concerning functionally related businesses and program-related investments, spending for charitable purposes, and the qualified appreciated stock rule.

There was some hope that the proposed Department of the Treasury regulations concerning donor-advised funds would materialize during the period—they are likely to constitute the stuff of a supplement by themselves—but, to date, nothing in that regard has occurred.

A supplement of this nature would not be complete without an update on applicable law generated by the Tax Cuts and Jobs Act. Included in this supplement are summaries of the Treasury Department's and the IRS's regulation on the bucketing and excess compensation tax laws. Discussion of the latter has been expanded to include summaries of exceptions particularly applicable to private foundations. A section has also been added discussing proposed legislation, the "Accelerating Charitable Efforts Act," which if enacted would make significant changes to the tax law applicable to private foundations and to donor-advised funds and the ways in which private foundations currently utilize them.

The discussion of the IRS's rules concerning private foundations' funding of disaster relief programs has been expanded and a section has been added on

## PREFACE

the import of the prospective revision of the group exemption rules. In celebration (if that is the right word) of the 50-year existence of the private foundation tax laws, a brief perspective on that phenomenon is included.

A new chapter has also been added covering tax reporting and administration issues, including Form 990-PF filing requirements, penalties and automatic revocation for non-filing, public disclosure and inspection requirements, and reporting and payment of private foundation excise taxes on Form 4720. This new chapter also includes an expanded discussion of abatement of the private foundation excise taxes and consolidates that discussion in one place in the book rather than treating it separately across the several chapters dealing with each private foundation excise tax.

Thanks go to Brian T. Neill, Deborah Schindlar, and Selvakumaran Rajendiran at John Wiley & Sons, Inc., for their hard work and invaluable help in connection with preparation of this supplement.

Bruce R. Hopkins  
Shane T. Hamilton

# Book Citations

Throughout this book, 11 books by the authors (in some instances, as co-author), all published by John Wiley & Sons, are referenced in this way:

1. Hopkins, *IRS Audits of Tax-Exempt Organizations: Policies, Practices, and Procedures* (2008): *IRS Audits*.
2. Hopkins, *The Law of Fundraising, Sixth Edition* (2022): *Fundraising*.
3. Hopkins, *The Law of Intermediate Sanctions: A Guide for Nonprofits* (2003): *Intermediate Sanctions*.
4. Hopkins, *The Law of Tax-Exempt Organizations, Twelfth Edition* (2019): *Tax-Exempt Organizations*.
5. Hopkins, *Nonprofit Governance: Law, Practices & Trends* (2009): *Nonprofit Governance*.
6. Hopkins, *Nonprofit Law for Colleges and Universities: Essential Questions and Answers for Officers, Directors, and Advisors* (2011): *Colleges and Universities*.
7. Hopkins, *Planning Guide for the Law of Tax-Exempt Organizations: Strategies and Commentaries* (2004): *Planning Guide*.
8. Hopkins, *The Tax Law of Charitable Giving, Sixth Edition* (2021): *Charitable Giving*.
9. Hopkins, *The Tax Law of Unrelated Business for Nonprofit Organizations* (2005): *Unrelated Business*.
10. Hopkins, *The Law of Tax-Exempt Healthcare Organizations, Fourth Edition* (2013): *Healthcare Organizations*.
11. Hopkins, *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (2012): *Constitutional Law*.

The second, fourth, eighth, and tenth of these books are annually supplemented.



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# CHAPTER ONE

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## Introduction to Private Foundations

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### § 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

p. 1, first line. *Delete millions of and insert:*

over 1.5 million<sup>1</sup>

p. 1, second line. *Delete 98,000 and insert 90,000.*

p. 1. *Delete second paragraph.*

p. 2, note 1, third line. *Insert period following 26; delete remainder of note.*

p. 2, note 1. *Change footnote number to 1.1.*

---

<sup>1</sup>The IRS Data Book, 2021 (Pub. 55-B) informs that there are, as of the federal government's fiscal year 2021, nearly two million recognized charitable and like organizations (including private foundations) in the United States, plus 109,468 nonexempt charitable trusts and split-interest trusts and 219 apostolic entities. This number of charitable organizations does not include religious organizations that are not required to seek recognition of tax exemption or entities covered by a group exemption.

## § 1.2 DEFINITION OF PRIVATE FOUNDATION

p. 5, note 10. *Insert before period:*

; IRS Revenue Procedure (Rev. Proc.) 2022-5, 2022-1 I.R.B. 256, § 7.03

## § 1.4 PRIVATE FOUNDATION LAW PRIMER

p. 8, last line. *Insert footnote 22.1 following period:*

<sup>22.1</sup>IRC Chapter 42 (IRC §§ 4940–4948).

p. 9, note 28. *Delete § 12.1, 12.2 and insert 12.1(a).*

p. 9, note 30. *Delete 12.3(b) and insert 12.4.*

p. 9, note 33. *Delete 1.10 and insert 12.5(c).*

p. 11, fourth line. *Delete Tax abatement and insert Abatement of the initial tax on self-dealers and foundation managers.*

p. 11, fourth and fifth lines. *Delete in this context.*

p. 11, note 44. *Delete 6.7 and insert 12.5(c).*

p. 11, note 47. *Delete 7.6 and insert 12.5(c).*

p. 12, note 51. *Delete 8.4 and insert 12.5(c).*

p. 13, note 59. *Delete 9.10 and insert 12.5(c).*

## § 1.5 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT

p. 16, note 75. *Delete second 75.; convert semi-colon to period and delete remainder of note.*

p. 16, note 76. *Convert semi-colon to period and delete remainder of note.*

p. 16, note 77. *Convert semi-colon to period and delete remainder of note.*

p. 16, note 78. *Convert semi-colon to period and delete remainder of note.*

p. 16, note 79. *Convert semi-colon to period and delete remainder of note.*

p. 16, note 82. *Convert semi-colon to period and delete remainder of note.*

## § 1.6 DEFINITION OF CHARITY

p. 17, note 85. *Convert semi-colon to period and delete remainder of note.*

p. 17, note 86. *Convert semi-colon to period and delete remainder of note.*

p. 17, note 87. *Convert second comma to period and delete remainder of note.*



## § 1.7 OPERATING FOR CHARITABLE PURPOSES

**p. 18, carryover paragraph, first line.** *Insert footnote 88.1 following period:*

<sup>88.1</sup>Reg. § 1.501(c)(3)-1(c)(1).

**p. 18, carryover paragraph, sixth line.** *Delete organizational and insert operational.*

**p. 18, carryover paragraph.** *Delete fifth complete sentence, including footnote.*

**p. 18, note 89.** *Delete text and insert:*

A private foundation had its tax-exempt status revoked for failing to engage in any exempt activities over a long period of time (Community Education Foundation v. Commissioner, 112 T.C.M. 637 (2016), appeal dismissed due to lack of representation by legal counsel).

**p. 18, note 90.** *Delete text and insert:*

In general, *Tax-Exempt Organizations* § 4.4.

**p. 19, note 102.** *Delete text beginning with and and through Compliance.*

## § 1.9 PRIVATE FOUNDATION SANCTIONS

**p. 24.** *Change heading to read:*

### PRIVATE FOUNDATION LAW SANCTIONS

**pp. 24–26.** *Delete text following heading on page 24 and through the first complete paragraph on page 26, and insert:*

The federal tax rules pertaining to private foundations<sup>136</sup> are often characterized in summaries as if they are typical laws, in the sense of prescriptions governing human behavior. This is not the case; these rules, comprising portions of the Internal Revenue Code, are tax provisions. Thus, this body of law states that, if a certain course of conduct is engaged in (or, perhaps, not engaged in), imposition of one or more excise taxes will be the (or a) result. For example, there is no rule of federal tax law that states that a private foundation may not engage in an act of self-dealing;<sup>137</sup> rather, the law is that an act of self-dealing will trigger one or more excise taxes and other sanctions.<sup>138</sup>

<sup>136</sup>E.g., § 1.4(a)–(h).

<sup>137</sup>State law, however, may contain such a rule. E.g., Neb. Rev. Stat. § 21-1916.

<sup>138</sup>Even the IRS occasionally gets this wrong. For example, in a private letter ruling, the IRS stated that certain payments by a private foundation to disqualified persons “would be acts of self-dealing that are prohibited by Chapter 42 of the Internal Revenue Code” (Priv. Ltr. Rul. 201703003).

**(a) Sanctions (a Reprise)**

Because of the nature of this statutory tax law structure, a person subject to an excise tax does not merely pay it and continue with the transaction and its consequences, as is the case with nearly all federal tax regimes. This structure weaves a series of spiraling taxes from which the private foundation, and/or disqualified person(s) with respect to it, can emerge only by paying one or more taxes and correcting (undoing) the transaction involved by paying or distributing assets or having the foundation's income and assets confiscated by the IRS.

The private foundation rules collectively stand as sanctions created by Congress for the purpose of curbing what was perceived as a range of abuses being perpetrated through the use of private foundations by those who control or manipulate them. These provisions comprise Chapter 42 of the Internal Revenue Code. Some of these constraints were placed on supporting organizations and donor-advised funds in 2006.<sup>139</sup>

**(b) Self-Dealing Sanctions as Pigouvian Taxes**

In the self-dealing context, two excise taxes are imposed on self-dealers—the initial tax<sup>140</sup> and the additional tax.<sup>141</sup> The first tax has a rate of 10 percent; the second a rate of 200 percent. There are also taxes on foundation managers where there is knowing participation in the self-dealing transaction (a *scienter* requirement).<sup>142</sup> The foundation self-dealing tax subjects the entire amount involved in a self-dealing transaction to tax. Also, the initial self-dealing tax cannot be abated by the IRS.<sup>143</sup> There is the correction feature, by which the self-dealer is required to pay the amount involved to the foundation.<sup>144</sup>

What has come to be known as the *Pigouvian tax* is the brainchild of English economist Arthur Cecil Pigou (1879–1959), a contributor to modern welfare economics. He introduced the concept of *externality* and the belief that externality (social problems) can be corrected by imposition of a tax. A commentator wrote that Pigouvian taxes “aim to regulate behavior by placing a small tax, usually in the form of a uniform excise tax, on the activity to be regulated because of the harm it produces for members of the public.”<sup>145</sup>

<sup>139</sup>See Chapters 15 and 16.

<sup>140</sup>IRC § 4941(a)(1).

<sup>141</sup>IRC § 4941(b)(1).

<sup>142</sup>IRC § 4941(a)(2), (b)(2).

<sup>143</sup>IRC § 4962(b).

<sup>144</sup>IRC § 4941(e)(3).

<sup>145</sup>Aprill, “The Private Foundation Excise Tax on Self-Dealing: Contours, Comparisons, and Character,” 17 *Pitt. L. Rev.* 297 (Spring 2020).

Does the federal self-dealing tax regime constitute one or more Pigouvian taxes? On the face of it, the answer would seem to be yes.<sup>146</sup> This commentator nicely observed that the self-dealing taxes “have the Pigouvian impulse to protect the public from harm by imposing an excise tax.”<sup>147</sup> Despite this impulse, however, three reasons were posited why the self-dealing taxes are not Pigouvian in nature. One, the additional excise tax rate of 200 percent is not “small.” Two, the initial tax subjects the entire amount involved in a self-dealing transaction to tax, “even if the transaction benefits the foundation,” so that, in those circumstances, the requisite “social costs” are not involved.<sup>148</sup> Third, a Pigouvian tax assumes uniform social costs across all individuals and firms; the commentator mused whether “differences between large and small foundations, between corporate and family foundations, local and national foundations, old and new foundations, etc. should shape the applicable excise tax rules.”<sup>149</sup>

Yet, it is understandable why one, perhaps not an economist, would conclude that the self-dealing taxes are Pigouvian in nature, if only because the initial tax cannot be abated and because of the correction requirement. The U.S. Supreme Court stated the general rule about a tax: “Imposition of a tax nonetheless leaves an individual with a lawful choice to do or not do a certain act, so long as he is willing to pay a tax levied on that choice.”<sup>150</sup> The self-dealing tax regime does not allow for that type of “lawful choice.”

### (c) Self-Dealing Sanctions: Taxes or Penalties?

Federal constitutional law differentiates between a tax and a penalty—at least conceptually. This distinction may be drawn in determining whether the exaction passes constitutional muster. A dramatic illustration of this point occurred when a bare majority of the U.S. Supreme Court upheld the constitutionality of the Patient Protection and Affordable Care Act (the “Affordable Care Act”) on the basis of Congress’s taxing power, construing the health insurance individual mandate (or shared-responsibility payment) as a tax, after the decision was made that the mandate could not be justified as constitutional pursuant to the Commerce Clause.<sup>150.1</sup> On that occasion, however, the Court observed that

<sup>146</sup>This is because of the inherent purpose of these taxes, which is to regulate behavior, with the sanctions more in the nature of penalties than taxes (see § 1.9(c)).

<sup>147</sup>Aprill, *supra* note 145, at 329.

<sup>148</sup>*Id.* at 328.

<sup>149</sup>*Id.*

<sup>150</sup>National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 574 (2012).

<sup>150.1</sup>*Id.* The Taxing Clause is the subject of U.S. Constitution Article I § 8. For a detailed summary of this opinion, see *Constitutional Law* § 4.8.

“Congress’s ability to use its taxing power to influence conduct is not without limits.”<sup>150.2</sup>

In this opinion, the fact that there is a difference between a tax and a penalty was raised, but not resolved. The Court wrote that “there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty with the characteristics of regulation and punishment.”<sup>150.3</sup> Also, the Court stated that, “[i]n distinguishing penalties from taxes, this Court has explained that ‘if the concept of penalty means anything, it means punishment for an unlawful act or omission.’”<sup>150.4</sup> The Court concluded, having decided that the individual mandate (or shared-responsibility payment) is a tax for constitutional law purposes, wrote that “we need not here decide the precise point at which an exaction becomes so punitive that the taxing power does not authorize it.”<sup>150.5</sup> It should be remembered that, even if an exaction is determined to be a penalty, the constitutionality of the statutory structure may be upheld under the Commerce Clause.<sup>150.6</sup>

In the opinion, the Court principally relied on two of its precedents in discussing what is and is not a tax. In one of these cases, decided in 1953, the Court wrote that a “federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed.”<sup>150.7</sup> It was stated that a tax may have a “regulatory effect” but remains a tax if it “produces revenue.”<sup>150.8</sup> The Court added: “It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical

<sup>150.2</sup>National Federation of Independent Businesses, *supra* note 150 at 572.

<sup>150.3</sup>*Id.* at 573.

<sup>150.4</sup>*Id.* at 567, quoting *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996).

<sup>150.5</sup>National Federation of Independent Businesses, *supra* note 150 at 573 (2012). Earlier in its opinion, the Court majority held that the payment was not a tax for statutory law purposes.

<sup>150.6</sup>The shared-responsibility payment was reduced to zero, effective January 1, 2019, by enactment of the Tax Cuts and Jobs Act (Pub. L. No. 115-97, 131 Stat. 2054 (2017)). A federal court held that the entirety of the Affordable Care Act, as modified by the TCJA, is unconstitutional because the individual mandate is now unconstitutional because it can no longer be justified as a tax and the mandate is inseverable from the Act’s remaining provisions (*Texas v. United States*, 336 F. Supp. 3d 664 (N.D. Tex. 2018)). An appellate court agreed with the district court as to the present-day unconstitutionality of the individual mandate but remanded the case for a more detailed analysis as to severability (*Texas v. United States*). The U.S. Supreme Court, on January 21, 2020, declined to expedite its review of this case (*U.S. House of Representatives v. Texas*, No. 19-841; *California v. Texas*, No. 19-840). The Fifth Circuit, on January 29, 2020, denied a request for a full-panel hearing of the case (*Texas v. United States*, No. 19-10011). The U.S. Supreme Court ended this litigation by holding that the plaintiffs lacked standing (*California v. Texas*, No. 19-840).

<sup>150.7</sup>*United States v. Kahriger*, 345 U.S. 22, 28 (1953).

<sup>150.8</sup>*Id.*

to the public welfare.”<sup>150.9</sup> In the other of these cases, the Court concluded that an ostensible tax was a penalty, because the sanction imposed a heavy burden, included a scienter requirement, and was enforced by a federal agency other than the Department of the Treasury.<sup>150.10</sup>

The Supreme Court observed, in 1974, that the Court in some of its early cases “drew what it saw at the time as distinctions between regulatory and revenue-raising taxes,” adding “[b]ut the Court has subsequently abandoned such distinctions.”<sup>150.11</sup>

Several court opinions focus on the constitutionality of the federal self-dealing law. In one of these cases, the principal contention was that the provision is an unconstitutional extension of the congressional taxing power.<sup>150.12</sup> That is, the allegation in that case was that the purpose of the statute is not to raise revenue but to regulate private foundations by imposing penalties on persons who use them for noncharitable, private purposes. The court involved rejected the contention.

The court began its analysis by observing that, in its early decisions analyzing the constitutionality of tax statutes, the Supreme Court “often drew distinctions between regulatory and revenue raising taxes.”<sup>150.13</sup> The court, however, wrote that the Court “has subsequently abandoned such distinctions.”<sup>150.14</sup> The court quoted a 1937 Supreme Court opinion stating that “[i]t is beyond serious question that a tax does not cease to be valid merely because it regulates, discourages, or definitely deters the activity taxed.”<sup>150.15</sup> In that opinion, the Court wrote that this “principle applies even though the revenue obtained is obviously negligible”<sup>150.16</sup> “or the revenue purpose of tax may be secondary.”<sup>150.17</sup> The Court also stated: “Nor does a tax statute necessarily fall because it touches on activities which Congress may not otherwise regulate.”<sup>150.18</sup> The court concluded that, “[u]nder the present posture of the law, tax statutes are constitutional unless they contain provisions which are extraneous to any tax need.”<sup>150.19</sup>

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<sup>150.9</sup> *Id.*

<sup>150.10</sup> *Bailey v. Drexel Furniture*, 259 U.S. 20 (1922).

<sup>150.11</sup> *Bob Jones University v. Simon*, 416 U.S. 725, 791, n.12 (1974).

<sup>150.12</sup> *Rockefeller v. United States*, 572 F. Supp. 9 (E.D. Ark. 1982), *aff'd per curiam*, 718 F.2d 290 (8th Cir. 1983), *cert. den.*, 460 U.S. 962 (1984).

<sup>150.13</sup> *Id.* at 13, citing *Hill v. Wallace*, 259 U.S. 44 (1922); *Bailey v. Drexel Furniture Co.*, 259 U.S. 20 (1922); and *Helmig v. United States*, 188 U.S. 605 (1903).

<sup>150.14</sup> *Id.*, quoting *United States v. Sanchez*, 340 U.S. 42 (1950).

<sup>150.15</sup> *United States v. Sanchez*, 340 U.S. 42, 44–45 (1950), citing *Sonzinsky v. United States*, 300 U.S. 506, 513–514 (1937).

<sup>150.16</sup> *Id.* at 44.

<sup>150.17</sup> *Id.*, citing *Hampton & Co. v. United States*, 276 U.S. 394 (1928).

<sup>150.18</sup> *Id.*

<sup>150.19</sup> *Rockefeller*, *supra* note 150.12 at 13, citing *Kahrigier*, *supra* note 150.7.

This court stated that “[i]t is clear that [the self-dealing statute] is constitutional as measured by the standards set forth in [the 1953 case].”<sup>150.20</sup> It continued: “Congress has seen fit, in enacting the internal revenue laws, to grant tax exempt status to certain entities” and “has allowed individuals, corporations, and estates the right to escape taxation of the amounts donated for charitable purposes.”<sup>150.21</sup> “However,” the court wrote, “when Congress observed that its legislative grace was being abused, it enacted [the self-dealing statute] to insure that its original intent in granting non-taxable status was complied with.”<sup>150.22</sup> The court concluded that, “[a]lthough [the statute] has a regulatory effect on the activities of charitable organizations and might not raise any revenue, it insures that revenue will be collected under income, estate, and gift tax laws which otherwise might have gone uncollected.”<sup>150.23</sup>

Another court case directly involving a private foundation regulatory provision in relation to the sanction’s status as a tax is a challenge to the mandatory payout rule.<sup>150.24</sup> In that case as well, the argument was that, by enacting the provision, Congress exceeded its power to lay and collect excise taxes. The contention was that the provision does not impose a tax for constitutional law purposes but “imposes a penalty measured by a prescribed rate of return on the value of the foundation’s noncharitable property even though the foundation may have no income.”<sup>150.25</sup> The court rejoined that the Supreme Court “has repeatedly rejected this argument,” and found that a tax may be “a legitimate exercise of the taxing power” notwithstanding that it has a “collateral regulatory purpose and effect.”<sup>150.26</sup>

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<sup>150.20</sup>*Id.*

<sup>150.21</sup>*Id.*

<sup>150.22</sup>*Id.*

<sup>150.23</sup>*Id.* The court, in *Rockefeller*, decided that the first-tier self-dealing tax is a penalty for purposes of a rule concerning interest (IRC § 6601(3)). Likewise, *Farrell v. United States*, 484 F. Supp. 1097 (E.D. Ark. 1980); *Deluxe Check Printers, Inc. v. United States*, 14 Ct. Cl. 782 (1988), 15 Ct. Cl. 175 (1988), *rev’d on other issue*, 885 F.2d 848 (Fed. Cir. 1989). But see *Latterman v. United States*, 872 F.2d 564 (3d Cir. 1989). Two federal appellate courts rejected the argument that the self-dealing taxes are excise levies and held that these sanctions are penal in nature (*Mahon v. United States (In re Unified Control Systems, Inc.)*, 586 F.2d 1036 (5th Cir. 1978); *United States v. Feinblatt (In re Kline)*, 547 F.2d 823 (4th Cir. 1977)). Following a brief survey of some of this case law, in a case challenging the constitutionality of the self-dealing excise taxes, the U.S. Tax Court stated simply that it “find[s] no basis for holding any of the provisions of section 4941 unconstitutional (*Estate of Reis v. Commissioner*, 87 T.C. 1016, 1020 (1986)).

<sup>150.24</sup>*Stanley O. Miller Charitable Fund v. Commissioner*, 89 T.C. 1112 (1987). See Chapter 6.

<sup>150.25</sup>*Id.* at 1119.

<sup>150.26</sup>*Id.* at 1120, citing the discussion in *Sanchez*, *supra* note 150.15, at 44–45, of the Court’s decisions in *Sonzinsky*, *supra* notes 150.15 and 150.16, *Hampton*, *supra* note 150.17, and *Magnano Co. v. Hamilton*, 292 U.S. 40, 47 (1934). The court also rejected the taxpayer’s other arguments

This court wrote that, “[b]y enacting [the mandatory payout rule] ... Congress decided to subject tax-exempt private foundations to [the rule that the tax must be paid even though the foundation has no income] in order to deal with what it perceived to be an abuse of the foundation’s tax-exemption privilege,” in that “[w]hile donors to the exempt private foundation could receive substantial current tax benefits from their contributions, charity might receive no current benefits because the foundation invested in growth assets that produce no current income but are expected to increase in value.”<sup>150.27</sup> Although the court did not expressly so state, private foundations in this circumstance are required to dip into principal to make the required distribution.<sup>150.28</sup>

The legislative history of the self-dealing rules is replete with references to the sanctions as penalties. The report of the House Committee on Ways and Means accompanying its version of the 1969 tax legislation states that the “permissible activities of private foundations ... are substantially tightened to *prevent* self-dealing between the foundations and their substantial contributors.”<sup>150.29</sup> The committee added that it “has determined to generally *prohibit* self-dealing transactions and provide a variety and gradation of sanctions.”<sup>150.30</sup> In this report, there are numerous references to these sanctions as constituting “prohibitions” or arising out of “prohibited” conduct. Identical or similar language appears in the report of the Senate Committee on Finance in connection with its version of the 1969 legislation.<sup>150.31</sup> This continues to be the view of Congress on this topic, as reflected in a report issued by the Ways and Means Committee in 1996 referring to the private foundation rules as a “penalty regime.”<sup>150.32</sup>

A commentator, following a review of the case law, wrote that the “character” of the self-dealing and similar private foundation provisions “as a tax or a penalty seems uncertain” under the Supreme Court opinion upholding

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that the mandatory payment tax is a direct tax in violation of Art. 1, sec. 9; that the tax violates the Sixteenth Amendment; and that this form of taxation involves denial of due process in violation of the Fifth Amendment (inasmuch as a private foundation is given the choice to forfeit its tax-exempt status and thereby avoid having to make mandatory payouts).

<sup>150.27</sup>Stanley O. Miller Charitable Fund, , *supra* note 150.24 at 1122.

<sup>150.28</sup>See § 6.1.

<sup>150.29</sup>H. Rep. No. 91-413, 91st Cong., 1st Sess. (1969), Part I, at 4 (emphasis added).

<sup>150.30</sup>*Id.*, Part IV, at 21 (emphasis added).

<sup>150.31</sup>S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969).

<sup>150.32</sup>H. Rep. No. 104-506, 104th Cong., 2nd Sess. 56 (1996). This observation was made in the context of a discussion of the intermediate sanctions rules applicable with respect to public charities, social welfare organizations, and certain nonprofit insurance issuers (IRC § 4958), which in many ways are structured in the same fashion as the private foundation rules. In general, *Tax-Exempt Organizations*, Chapter 21.

the Affordable Care Act.<sup>150.33</sup> It is pointed out that the Court’s most recent discussion of what constitutes a penalty “turns, at least in part, not on the purpose of or motive for an assessment, but on its level—whether it imposes a heavy burden.”<sup>150.34</sup> Here are the features posed for such a “heavy burden” under the self-dealing sanctions regime: (1) the imposition of the first-tier level of taxation on the entire amount of a self-dealing transaction, rather than just the amount by which the foundation is harmed; (2) the second-tier tax rate of 200 percent, which “gives a disqualified person little if any meaningful choice of whether or not to pay the tax”; (3) the implication of the scienter requirement in connection with the excise taxes on foundation managers who knowingly participate in a self-dealing transaction; (4) the court opinions that view the self-dealing sanctions as having the “regulatory purpose [of] rendering self-dealing unlawful”; and (5) the IRS’s inability to abate the first-tier excise tax.<sup>150.35</sup> A sixth indicator of penalty status in this context may be the correction requirement.

This commentator concludes that “private foundation excise taxes do not fit easily into either the category of constitutional taxes or constitutional penalties.”<sup>150.36</sup> As to the self-dealing taxes, the commentator writes that the “status of section 4941 is uncertain under [the Supreme Court opinion upholding the Affordable Care Act], under the private foundation cases from the 1980s, and the positions of key governmental bodies.”<sup>150.37</sup> Nonetheless, a good case can be made, at least as to the self-dealing tax regime, that the sanctions amount to one or more penalties. The Pigouvian impulse tugs.

#### **(d) Abatement**

**p. 26, note 152.** *Insert following existing text:*

See § 12.5(c).

**p. 26, second complete paragraph, last line.** *Delete in the self-dealing setting and insert with respect to the initial tax on acts of self-dealing.*

**pp. 26–27.** *Delete text beginning with third complete paragraph on page 26 and through the last complete paragraph on page 27.*

**p. 27.** *Insert before carryover paragraph:*

<sup>150.33</sup> Aprill, *supra* note 145, at 322; see National Federation of Independent Businesses, *supra* note 150.

<sup>150.34</sup> *Id.*

<sup>150.35</sup> *Id.*

<sup>150.36</sup> *Id.* at 323.

<sup>150.37</sup> *Id.* at 325.



**(e) Potential of Overlapping Taxes**

Taxes under more than one provision of the private foundation excise tax regime<sup>153</sup> may be imposed with respect to a single transaction.<sup>154</sup> Indeed, a tax regulation states that “[i]t is not intended that the taxes imposed under Chapter 42 be exclusive.”<sup>155</sup> For example, if a private foundation purchases a sole proprietorship in a business enterprise,<sup>156</sup> in addition to become subject to excess business holding taxation,<sup>157</sup> the foundation may be liable for tax under the jeopardizing investment tax regime<sup>158</sup> if the investment jeopardizes the carrying out of any of the foundation’s exempt purposes.<sup>159</sup>

As another illustration of this topic, the IRS ruled that a private foundation’s disaster relief and emergency hardship program<sup>160</sup> furthered the interests of a corporation and its subsidiaries, who were disqualified persons with respect to the foundation,<sup>161</sup> and thus that grants distributed in accordance with the program constituted acts of self-dealing.<sup>162</sup> The IRS then proceeded to rule that the grants were also not qualifying distributions<sup>163</sup> and were taxable expenditures,<sup>164</sup> thus subjecting the foundation to both taxes on self-dealing and taxes on taxable expenditures.<sup>165</sup> Likewise, in a case involving private foundation loans to a disqualified person, the IRS ruled, of course, that the loans were acts of self-dealing,<sup>166</sup> then added that they were also jeopardizing investments.<sup>167</sup>

**(f) Influence on Subsequent Law**

**pp. 27–28, carryover paragraph. *Change footnotes 159 to 162 to footnotes 168 to 171.***

<sup>153</sup>IRC Chapter 42 (IRC §§ 4940–4948).

<sup>154</sup>Rev. Rul. 77-161, 1977-1 C.B. 358 (“A given set of facts can give rise to taxes under more than one provision of chapter 42 of the Code”).

<sup>155</sup>Reg. § 53.4944-1(a)(2)(iv).

<sup>156</sup>See § 7.1(a).

<sup>157</sup>See § 7.7.

<sup>158</sup>See § 8.5.

<sup>159</sup>Reg. § 53.4944-1(a)(2)(iv). See § 8.1(a).

<sup>160</sup>See § 9.5A.

<sup>161</sup>See Chapter 4.

<sup>162</sup>See § 5.8(c).

<sup>163</sup>See § 6.5(a).

<sup>164</sup>See § 9.9.

<sup>165</sup>Priv. Ltr. Rul. 199914040. See §§ 5.15(d), 9.11.

<sup>166</sup>See § 5.5.

<sup>167</sup>Priv. Ltr. Rul. 201326019. See § 8.1(a).

## § 1.10 STATISTICAL PROFILE

### p. 28. *Delete last two paragraphs and insert:*

There are about 90,000 private foundations in the United States, thus accounting for a small percentage of tax-exempt charitable organizations in the sector. As of 2017, foundations held over \$1 trillion in assets or about 1 percent of the net worth in the United States overall. Yet, on the basis of data for 2018, it is estimated that all nonprofit organizations had a collective net worth of \$6.7 trillion; therefore, private foundations account for over one-seventh of assets held in the nonprofit sector.<sup>172</sup>

## § 1.11 PRIVATE FOUNDATIONS AND LAW 50 YEARS LATER

Notwithstanding the passage of more than 50 years, the statutory tax law regulating private foundations that was enacted in 1969—the infamous IRC Chapter 42—has not changed much. There have, of course, been some revisions, but the basic framework remains in place. There are several reasons for this phenomenon, one of them being the excellent craftsmanship that was employed when the initial statutory regime was formulated. This body of law is tough and comprehensive, although, five decades later, probably unnecessarily rigid and inequitable in places.

Parallel to the endurance of this statutory scheme has been the steady growth of the private foundation community. Today, there are, as noted, about 90,000 private foundations; all of the metrics reflect steady expansion: the sheer numbers of them, asset size, grant amounts, and the like. Foundations have persisted, notwithstanding this heavy mantle of statutory restrictions and penalty taxes (that essentially amount to prohibitions).<sup>173</sup>

This endurance and growth were not anticipated in all quarters in the immediate aftermath of enactment of the Tax Reform Act of 1969.<sup>174</sup> A chronicler of this 50-year period<sup>175</sup> collected some predictions issued in those early years. In one, two commentators characterized the effect of the Act as Congress having “thrown out the charitable baby with the dirty bathwater,” “encouraging the abandonment” of private foundations, “interfering with

<sup>172</sup>These data are collected in Steuerle and Soskis, “Taxes and Foundations: A 50th Anniversary Overview,” published by the Tax Policy Center, Urban Institute, and Brookings Institution (Feb. 8, 2020) (Steuerle & Soskis Paper). A subsequent report stated that there are over 1.9 million tax-exempt organizations in the United States (IRS Data Book, 2020 (Pub. 55-B) at 23).

<sup>173</sup>See § 1.9. Two commentators nicely portrayed the Act as a “regulatory fusillade” on private foundations (Steuerle & Soskis Paper at 21).

<sup>174</sup>See § 1.3.

<sup>175</sup>Orol, “The Failures and the Future of Private Foundation Governance,” 46 *ACTEC L. Jour.* (No. 2) 185 (Spring 2021) (Orol Article).

their effective operation, attacking their involvement in major social problems and prohibiting what are in essence equitable transactions.<sup>176</sup> In another, the forecast was that “[a]ll of the odds seem stacked against” the growth of foundations, “given the range of disincentives built into the law.”<sup>177</sup> Yet, private foundations have proved resilient and remain a major force in contemporary philanthropy.<sup>178</sup>

There have, however, been two generally unanticipated consequences of enactment of Chapter 42. Congress has proved adept at extending some of the private foundation law to other types of tax-exempt charitable entities. For example, aspects of the excess business holdings rules were subsequently extended to certain supporting organizations<sup>179</sup> and to donor-advised funds.<sup>180</sup> The private foundation self-dealing rules heavily influenced the shaping of the excess benefit transaction rules.<sup>181</sup> Indeed, the very concept of underlying regulatory rules with a system of excise taxes, initiated with Chapter 42, is reflected in the excess benefit transaction rules,<sup>182</sup> public charity lobbying rules,<sup>183</sup> public charity political campaign activities rules,<sup>184</sup> and the donor-advised fund statutory law.<sup>185</sup>

The other unanticipated consequence of enactment of the private foundation tax laws is the rise of alternative entities. The most notable aspect of this development has been, and continues to be, the stupendous rise of the donor-advised fund.<sup>186</sup> Donor-advised funds often are used in lieu of private foundations, for a variety of reasons, including the absence of a need to create and sustain a governing board, apply for recognition of exempt status, file annual information returns, and be subject to the mandatory payout rules, not to mention the lack of sufficient financial resources to warrant the formation and operation of a private foundation.<sup>187</sup>

<sup>176</sup>Goldstein and Sharpe, “Private Charitable Foundations After Tax Reform,” 56 *A.B.A.J.* 447, 452 (May 1970).

<sup>177</sup>Wadsworth, “Private Foundations and the Tax Reform Act of 1969,” 39 *Law & Contemp. Probs.* 255, 262 (1975). This article and the one cited in *supra* note 182 are cited in the Orol Article at 145.

<sup>178</sup>As one observer stated the matter, the “overwhelming consensus is that foundations have thrived in spite of, and not because of, the Tax Reform Act” (Orol Article at 210).

<sup>179</sup>See § 7.5.

<sup>180</sup>See § 7.6.

<sup>181</sup>IRC § 4958. See *Tax-Exempt Organizations*, Chapter 21.

<sup>182</sup>*Id.*

<sup>183</sup>*Id.*, Chapter 22.

<sup>184</sup>*Id.*, Chapter 23.

<sup>185</sup>See § 16.9.

<sup>186</sup>See Chapter 16.

<sup>187</sup>See Chapter 16; *Tax-Exempt Organizations* § 11.8; *Charitable Giving* § 21.4; Hopkins, *Donor-Advised Funds: Law and Policy* (Pittsburgh, PA: Dorrance Publishing, 2020).

The other primary alternative to the private foundation is the tax-exempt social welfare organization.<sup>188</sup> In this context, the concept of *social welfare* is commensurate with the “common good and general welfare” and “civic betterments and social improvements.”<sup>189</sup> This concept is certainly broader than the concept of what is *charitable*.<sup>190</sup> A federal income tax charitable contribution deduction is not likely to be available in instances of transfers to social welfare organizations but donors may nonetheless make gifts to these entities, including gifts of appreciated property,<sup>191</sup> and avail themselves of the federal gift tax charitable deduction.<sup>192</sup> These entities are not required to file for recognition of exemption,<sup>193</sup> may engage in political campaign activities, and are not subject to private foundation laws concerning self-dealing,<sup>194</sup> mandatory payouts, excess business holdings limitations, and the like. Donors, it is said, “are flocking to 501(c)(4) organizations.”<sup>195</sup>

The previously referenced chronicler asserts that the “large number of existing private foundations and the significant value of their holdings mask a deep-seated and growing frustration with the restrictions imposed by the [Tax Reform] Act that threatens to dethrone the private foundation from its historical primacy in the field of private philanthropy.”<sup>196</sup> The combination of various issues in play, discussed below, it is contended, have “precipitate[d] the decline of private foundations in favor of substantially—and arguably, troubling—less restrictive alternatives, which are largely structured in ways that make it less likely that they will achieve the type of broad-ranging social benefit that private foundations have historically fostered.”<sup>197</sup>

This analysis concluded that there is a “lack of public confidence in the regulatory regime” applicable to private foundations.<sup>198</sup> Five reasons are given for this development: (1) The “single most significant source of the rules’ negative consequences is their undue complexity,” which (ostensibly) leads to “an explosion in administrative costs” due to legal fees,<sup>199</sup> (2) the dramatic

<sup>188</sup>This type of entity is exempt from tax under IRC § 501(a) as an organization that is described in IRC § 501(c)(4). See *Tax-Exempt Organizations*, Chapter 13.

<sup>189</sup>Reg. § 1.501(c)(4)-1(a)(2)(i).

<sup>190</sup>See § 1.6.

<sup>191</sup>See *Charitable Giving* § 3.3.

<sup>192</sup>IRC § 2501(a)(6). See *Charitable Giving* § 6.2(g).

<sup>193</sup>These organizations are, however, required to timely file a notice with the IRS (IRC § 506(a); see *Tax-Exempt Organizations* § 26.13).

<sup>194</sup>These organizations are, however, subject to the excess benefit transactions law (see *supra* note 187).

<sup>195</sup>Orol Article at 229.

<sup>196</sup>*Id.* at 186.

<sup>197</sup>*Id.* at 187.

<sup>198</sup>*Id.* at 213.

<sup>199</sup>*Id.* at 213–215.

decrease in IRS guidance in the private foundation field;<sup>200</sup> (3) many of the private foundation laws are bright-line rules that, while easier to administer, lead to over-inclusiveness in the form of unnecessary and often unfair penalties;<sup>201</sup> (4) Congress and the public remain skeptical of private foundations, in part because of ongoing “undercurrents of anxiety about wealth,” foundations’ “control over charitable priorities,” some well-publicized abuses, and (sometimes) lack of efficacy of the foundation laws;<sup>202</sup> and (5) the previously discussed rise in alternatives to private foundations.<sup>203</sup>

This chronicler is of the view that what is needed is a “clean slate for foundation governance,”<sup>204</sup> that is, foundation regulation. This is because the rules are “hopelessly complicated and penalize behavior that is not only not harmful but may in fact be beneficial for philanthropy.”<sup>205</sup> In this regard, particular focus is placed on the self-dealing rules. Your authors are of the view that such a “clean slate” is unlikely for the foreseeable future and that, while the self-dealing and other foundation rules are indeed complex, the state of affairs is not so dire as to be “hopeless.” The foundation community appears to have largely learned to accommodate the rules, advised by far more lawyers who are proficient in private foundation law than was the case many years ago. There is, however, room for more flexibility and equity in the private foundation self-dealing rules, and the IRS should be accorded authority to abate the self-dealing taxes.

This analysis raises the matter of the private foundation net investment income excise tax. As is well-known, this tax was originally touted as an “audit fee,” the purpose of which was to fund IRS oversight of private foundations and other components of the charitable sector—an outcome that never materialized. (It has never been clear as to why this earmarking of funds has never occurred.)<sup>206</sup> The analysis calls for reinstatement of this tax as an audit fee, with that law change unleashing a “cascade of benefits,” including removal of bright-line rules in the self-dealing law and enabling foundations to “engage in certain behavior that is now penalized but would ultimately

<sup>200</sup>*Id.* at 215–216.

<sup>201</sup>*Id.* at 216–219.

<sup>202</sup>*Id.* at 219–225.

<sup>203</sup>*Id.* at 225–230.

<sup>204</sup>*Id.* at 230.

<sup>205</sup>*Id.*

<sup>206</sup>Two commentators dismiss this “audit fee” rationale as a mere “excuse,” asserting that the true purpose of this tax is an “attack . . . on institutions thought to be controlled by the wealthy or benefiting an elite” (Steuerle & Soskis Paper at 27). The same may be said for the excise tax on college and university endowments (IRC § 4968; *Tax-Exempt Organizations* § 11.9(b)). One analysis states that, absent the audit-fee rationale, “it is difficult to justify the tax at all” (Orol Article at 233).

be beneficial charitable causes.”<sup>207</sup> Of course, an alternative is to repeal the tax, perhaps freeing up more funds for charitable purposes. In any event, the attitude in Congress about funding the IRS is shifting; the agency may soon have additional billions of dollars to spend on examinations and other forms of tax law enforcement.

Another area that is said to need improvement is IRS enforcement of the private foundation rules. It is common knowledge that the IRS is presently lacking in resources in this regard. The nation, however, appears to be entering an era of higher income taxes, increased funding of the IRS, and greater focus on audits of wealthy individuals. There is a correlation between this point and the prior one: “A more robust and well-resourced [IRS] audit function would allow us to move away from the bright-line rules that have proven to be overbroad and exceedingly complex.”<sup>208</sup> One approach, as the chronicler noted, would be to return to the original concept of earmarking the funds generated by the tax on private foundations’ net income for audits of foundations (and perhaps other categories of tax-exempt organizations).

This review of 50 years of experience with the private foundation tax laws observed that Congress “has the opportunity to retool the private foundation regulatory regime to ensure that private foundations maintain their place of primacy in private philanthropy and continue to deliver [their] socially-beneficial results.”<sup>209</sup> Such a revision of this regulatory regime, however, certainly is not imminent. Indeed, the trend appears to be to leave the private foundation laws as they are and extend them to other exempt entities<sup>210</sup> or create new forms of comparable regulation (such as in the case of donor-advised funds).

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<sup>207</sup>Orol Article at 234.

<sup>208</sup>*Id.* at 230.

<sup>209</sup>*Id.* at 237.

<sup>210</sup>E.g., see text accompanied by *supra* notes 179 and 180.