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The Treasury Report on Foundations:Methods of Enforcing Compliance

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Mr. Allen discusses the various sanctions which might be used to implement the proposals made in the 1965 Treasury Report on Private Foundations and suggests which sanctions would be most appropriate. His conclusion dwells on the theme that imposition of the tax is not necessarily the wisest sanction. Viewing the Treasury proposal as a call for wide reform in the charitable foundation field, the author would prefer that sanctions be limited to those designed to induce state action.

I. INTRODUCTION

Concern about philanthropy, and in particular about philanthropic foundations, seems to go through a cyclical pattern: a period of quiet contentment, and then a time of alarm and crisis.[1]

If Professor Sacks is correct in his cyclical view of the public concern over charitable foundations, the present period must surely be classed as one of maximum turbulence. At the moment both houses of Congress have had presented to them proposals for levying new restrictions on charitable foundations through the tax law,[2] a flood of law review comments has appeared,[3] and at the state level new legislation, partly directed to control of charitable foundations,

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1. Sacks, *Use and Misuse of the Private Foundation*, N.Y.U. 5TH CONFERENCE ON CHARITABLE FOUNDATIONS 203 (1961).

2. CHAIRMAN'S REPORT TO THE SELECT COMM. ON SMALL BUSINESS OF THE HOUSE OF REPRESENTATIVES, 87TH & 88TH CONGS., TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY (Comm. Print: 1st installment, 1962; 2nd installment, 1963; 3rd installment, 1964) [hereinafter cited as PATMAN REPORT]; SENATE COMM. ON FINANCE, 89TH CONG., 1ST SESS., REPORT ON PRIVATE FOUNDATIONS (Comm. Print 1965) [hereinafter cited as TREASURY REPORT]. The hearings conducted by Mr. Patman *after* the issuance of the last volume of the Patman Report may be fonnd in *Hearings Before Subcommittee No. 1 on Foundations of the Select Committee on Small Business of the House of Representatives*, 88th Cong., 2nd Sess. (1964) [hereinafter cited as *Patman Hearings*].

3. *E.g.*, Folk, *Regulation of Charitable Foundations—The Patman and Treasury Reports*, 20 BUS. LAW. 1015 (1965); Karst, *The Tax Exemption of Donor-Controlled Foundations*, 25 OHIO ST. L.J. 183 (1964); Krasnowiecki & Brodsky, *Comment on the Patman Report*, 112 U. PA. L. REV. 190 (1963); Schoenfeld, *Initial Impressions of the Treasury Report on Foundations*, 14 CLEV.-MAR. L. REV. 286 (1965). No article found has directly considered the problem of appropriate sanctions for the *Treasury Report*. Some of the ideas for sanctions in this paper were suggested by a representative of the Treasury Department.

has been proposed, and in some cases adopted.[4]

The most comprehensive reappraisal of the area since 1950, the *U.S. Treasury Report on Private Foundations*,[5] is the subject of this paper. More specifically, after a general review of the background of the problem, this paper will discuss the various sanctions (tax or otherwise)[6] which might be used to implement the proposals made in the *Treasury Report*, the problems attendant to each sanction, and a mild attempt will be made to select the most appropriate sanctions.

The importance of the *Treasury Report*, its proposals and possible implementations, is reflected in the following statistics for 1962, the last year in which a comprehensive survey of charitable foundations was made.[7] In that year there were approximately 15,000 private foundations,[8] almost two-thirds of which were created after 1959.[9] These foundations had assets valued at over sixteen billion dollars,[10] and an income, including capital gains, in excess of one billion dollars.[11] And of the eight billion dollars contributed to charity in 1962,[12] 833 million dollars went to private foundations.[13]

As this paper is concerned primarily with sanctions, only those proposals in the *Treasury Report* for which no sanctions are specified will be treated. These are five in number:

1. Private foundations would be prohibited from dealing with any substantial contributor (including corporation officials), any officer, director, or trustee of the foundation, or any party closely related to them, except to pay reasonable compensation for necessary services and to make incidental purchases of supplies.

2. A private, non-operating foundation (as defined in section 170 (g)(2)(B)) would be required to distribute the full amount of its current net income by the end of the year following the year in which such income was earned. Or, if such foundation's income falls below a prescribed percentage of the value of its holdings, the foundation

4. UNIFORM SUPERVISION OF TRUSTEES FOR CHARITABLE PURPOSES ACT. At the beginning of 1965 three states, California, Michigan, and Oregon had adopted the Act. UNIFORM LAWS ANN. 138 (Supp. 1964).

5. TREASURY REPORT, *supra* note 2. For the origins of the *Treasury Report*, see Schoenfeld, *supra* note 3, at 286 n.2.

6. The Treasury apparently believes that these proposals and their sanctions can be appropriately subsumed under the federal tax laws. TREASURY REPORT 14. This paper assumes that this view is not necessarily correct, and examines non-tax sanctions and other approaches to the problem, as well as tax sanctions.

7. This survey was made by the Treasury Department and is reported in the *Treasury Report*.

8. TREASURY REPORT 74, table 7.

9. *Ibid.*

10. *Ibid.*

11. *Id.* at 79, table 10.

12. *Id.* at 67, table 2.

13. *Id.* at 79, table 10.

would be required to contribute the difference out of its corpus. Two recommended exceptions would allow the foundation (1) to accumulate income to the extent it had in a speciified prior period expended amounts in excess of its income, and (2) to accumulate income for a specified period if necessary to the accomplishment of a charitable purpose.

3. Private foundations would be prohibited from owning either twenty per cent or more of the total combined voting power or twenty per cent or more of the value of the equity of a corporation, if the corporation's business is not substantially related to the exempt functions of the foundation. If the business is unincorporated, a twenty per cent or larger interest in the capital or profits of the business would be forbidden. Interests in such businesses held (*e.g.*, by a trust arrangement) for the foundation would be attributed to it. Foundations would be given a reasonable time to divest themselves of such interests. Certain interests of a passive nature, such as the earning of interest, holdings of royalties and mineral production payments and certain leases would be exempted from the term "business." In addition, the three exceptions in section 513 of the Code (*e.g.*, work carried on without compensation) would also be applicable to this proposal.

4. Three proposals relating to financial transactions unrelated to charitable functions are subsumed here: (1) all foundation *borrowing* for investment purposes would be prohibited, although borrowing in order to carry out an exempt function would be allowed, as would investment transactions already in progress; (2) foundation *loans* would be confined to categories which are clearly necessary, safe, and appropriate for charitable fiduciaries, although again if the loan is in pursuance of an exempt purpose, (*e.g.*, loans to students) it may be made; (3) foundations would be prohibited from *trading and speculating* with any of their assets, whether corpus or income.

5. The donor of a foundation, his family, employees, and business associates would be barred after twenty-five years from comprising more than twenty-five per cent of the managing board of the foundation.

The report from which these proposals are taken was made by the Treasury at the request of Congress. On four previous occasions in the last sixteen years Congress has inquired into the role of charitable foundations. The first investigation,[14] in 1949, was primarily con-

14. *Hearings Before a Subcommittee of the Committee of Interstate and Foreign Commerce of the U.S. Senate on Investigation of Closing of Nashua, N.H. Mills and Operations of Textron, Inc.*, 80th Cong., 2d Sess. (1948); S. Rep. No. 101, 81st Cong., 1st Sess. (1949); S. Rep. No. 2375, 81st Cong., 2d Sess. 26-39 (1950).

cerned with the operations of Textron, Inc., and its use of charitable foundations. The disclosures made therein were primarily responsible for the passage of sections 502-04 and 511-15 of our present Code, the first, and so far the only, substantial restrictions on foundation activities. In 1953 and 1954 the so-called Cox[15] and Reece[16] Committees intensively investigated charitable foundations in response to charges that foundations were being used to further the purposes of Communists, leftists, liberals and others on the left side of the political spectrum. Comparatively little attention was given to other abuses or to the revision of the tax laws, and no new legislation resulted. Almost a decade later, the now famous *Patman Report* was issued.[17] This study, in the form of a report by Mr. Patman to his committee, recommended sweeping, and sometimes radical, changes in the laws governing charitable foundations. This report was the moving force behind the request for the *Treasury Report*.[18]

II. Sanctions in General

Before turning to a consideration of the specific proposals and appropriate sanctions for each, several matters of general application merit discussion.

A. *State Regulation*

Although the above-listed proposals cover areas which are of legitimate concern to the federal taxing authorities, these are areas which traditionally have been regulated by state law. For example, the proposals concerning self-dealing, delay in benefit to charity, and improper financial transactions sound in the area of state law of trusts and fiduciary responsibility. If for some reason proper control of such activities cannot be maintained at the state level, then the federal government would seem to have some obligation to regulate such matters, both because of its interest in protecting the revenues, and also because the federal government through its tax policy has in large part been responsible for the growth of modern day foundations.[19] With this residual federal responsibility in mind,[20] the follow-

15. *Hearings Before the Select Committee To Investigate Tax-Exempt Foundations and Comparable Organizations of the House of Representatives*, 82d Cong., 2d Sess. (1953); H.R. Rep. No. 2514, 82d Cong., 2d Sess. (1953).

16. *Hearings Before the Special Committee To Investigate Tax-Exempt Foundations and Comparable Organizations of the House of Representatives*, 83d Cong., 2d Sess. (1954); H.R. Rep. No. 2681, 83d Cong., 2d Sess. (1954).

17. Patman Report, *supra* note 2.

18. Schoenfeld, *supra* note 3, at 286 n.2. Consequently, the *Patman Report* is especially relevant in construing the *Treasury Report*.

19. "The unknown, but certainly rising, number of family foundations are a product of the tax structure." Kahn, Personal Deductions in the Federal Income Tax 67 (1960).

20. This is the underlying rationale of the *Treasury Report*: "Since the Federal tax

ing questions must be asked: Have the states effectively regulated these areas? If not, what are the prospects for such regulation, and what can the federal government do to promote such regulation?

While the situation in some states is better than in others, the overall view is dismal, for several reasons.[21] The law of charities is itself unsettled, and can be found ouly by consulting a state's tax, corporation, and trust laws. Where a charitable foundation is involved, there is the additional problem of determining whether state trust law, the usual vehicle for supervision of charities, including foundations, is applicable to foundations organized as corporations. Whatever the applicable law, the supervision of all charities is relegated to the state attorney general, there being no determinable beneficiary[22] of a charity with standing to bring suit. But the attorney general in most states has no practical way to determine even the existence of all the foundations subject to the state's jurisdiction, let alone a method of effectively examining foundation activity for abuses. In addition, a state attorney general "is also hampered by the common problems

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laws have played a significant part in the growth of foundations, an unavoidable responsibility rests upon the Federal Government to do what it reasonably can to insure that these organizations operate in a manner conducive to the fulfillment of their purposes." TREASURY REPORT 14.

21. For general discussion of the many problems in state regulation of charitable foundations, see Fremont-Smith, *Government Supervision and Accountability of Foundations,* N.Y.U. 6TH CONFERENCE ON CHARITABLE FOUNDATIONS 69 (1963); Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility,* 73 HARV. L. REV. 433 (1960).

22. In Ames v. Attorney General, 332 Mass. 246, 124 N.E.2d 511 (1955), a group of private citizens sought unsuccessfully to mandamus the state attorney general to have him "reconsider" his decision not to take action against a charity. This approach is somewhat similar to a sanction suggested by the Reece Committee: "As it is obvious that the Internal Revenue Service cannot, except at prohibitive cost, follow the activities of the individual foundations to ascertain whether violations of law exist, this Committee believes that some additional method should be established to protect the people against a misuse of the public funds which foundation money represents. An interesting suggestion has been made, which deserves careful study, that legal procedure should be available in the Federal courts under which a citizen could bring a proceeding to compel the Attorney General to take action against a foundation upon a showing, to the satisfaction of a Federal judge, that a *prima* facie or probable cause exists." H.R. REP. No. 2681, *supra* note 16, at 216. Another novel idea has been suggested by Professor Simon: "Even if these proposals were adopted there might still be some attorney generals too overworked or too disinterested to take action. If that should bappen in a notorious case, I wonder whether the local United States Attorney could not initiate the proceeding in state court. Does only the *state* sovereign stand as *parens patriae* to charity's beneficiaries? Does not the federal tax indulgence improve the United States' claim to this prosecuting role. These are questions deserving of further considerations in the event of flagrant laxity by a state attorney general." 1 HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., 1ST SESS., WRITTEN STATEMENTS BY INTERESTED INDIVIDUALS AND ORGANIZATIONS ON TREASURY DEP'T REP. 459-60 (Comm. Print 1965) [hereinafter cited as TREASURY REPORT STATEMENTS]. All these approaches have the virtue of not being dependent upon the state attorney general for initiation of action.

of all state administrators, a multitude of duties to perform, insufficient help and inadequate funds."[23]

One hopeful augury for the future is the Uniform Supervision of Trustees for Charitable Purposes Act, which would give the state attorney general broad powers of investigation, enforcement, rule-making, and disclosure. At present, however, the Act has been adopted by only three states.[24]

Some action by the federal government therefore seems necessary. For foundations not now in existence, as a condition of exemption it might be required that the foundation's charter or trust instrument contain whatever restriction the Treasury deems desirable for insuring the proper use of the exemption.[25] Such an approach would make it clear that a failure by a foundation official to comply with federal law would constitute a breach of fiduciary duty. It would be particularly useful for implementing those proposals which involve activities not prohibited by state law, such as a donor's retaining full control after twenty-five years, or the foundation's borrowing for investment. Moreover, by specifically proscribing certain activities by charter, the Treasury could insure that its proposals would be carried out uniformly without subjection to the vagaries of state law.

For foundations already in existence, the problem is more difficult, and perhaps less should be expected from federal attempts to spark state action than in the case of new foundations. One possible restriction would be a denial of the tax exemption to all foundations within a state not having an effective system for the supervision of its foundations.[26] The states could be given a reasonable period of

23. Fremont-Smith, *supra* note 21, at 79.

24. See note 4 *supra*. Another possibility for the future is self-regulation. See generally Caplin, *A Code of Practice is Needed*, N.Y.U. 7TH CONFERENCE ON CHARITABLE FOUNDATIONS 237 (1965); 1 TREASURY REPORT STATEMENTS 165. This was the hope of the Reece Committee, H.R. REP. No. 2681, *supra* note 16, at 212. In the absence of outside pressure, self-regulation seems unlikely.

25. This idea has been suggested by the New York State Bar Association Section on Taxation. 2 TREASURY REPORT STATEMENTS 713-14.

26. The following comments of Fremont-Smith are relevant on this point:

"It might be possible for Congress to permit the Revenue Service to withhold application of federal sanctions if a state has established a program that meets certain standards and has taken jurisdiction of a partieular case.

A financial incentive to the states, would, of course, be even more effective. It could take the form of a provision whereby, if a federal statute is violated, the charitable funds will be subject to a confiscatory tax unless the state takes steps to rectify the violation. Theoretically, a state should be interested enough in preserving funds donated for the benefit of its citizens to act to preserve them, but there is no guarantee of this.

"Most effective would be direct federal aid to states that have established programs which meet federally enacted requirements, perhaps similar to the provisions under which the federal unemployment insurance programs are administered." Fremont-Smith, *State Supervision of Foundation Activities*, N.Y.U. 7TH CONFERENCE ON CHARITABLE FOUNDATIONS 223, 235-36 (1965).

time (*e.g.*, two years) to pass necessary legislation, the nature of which might be left to the Treasury for determination. An obvious possibility would be the Uniform Supervision of Trustees for Charitable Purposes Act, or something similar.[27]

While adoption of this Act would not be an effective sanction for the *Treasury Report* proposals not already prohibited by state law,[28] perhaps its passage would eliminate the need for such restrictions. If not, the exemption could also be conditioned on passage of additional state legislation requiring existing foundations to comply with these proposals. However, state and federal constitutional questions may lurk here. For while the federal government can deny exemption to a foundation, for example, for borrowing for investment, this is only a question of denying that which was a matter of legislative grace to begin with. It is an entirely different matter for a state (or the federal government for that matter) by statute to change the terms of a private trust instrument governing private property, especially when the reason for such a law would be the state's desire for its foundations to receive the federal tax exemption.[29] In such a case some reliance might be placed on the doctrine of cy pres.

This sanction, of course, depends upon the likelihood of state compliance. Such compliance would probably be forthcoming, for a substantial amount of the states' welfare burden is no doubt carried by foundations, and loss of the federal tax exemption would greatly restrict the activities of such foundations, without providing a counterbalancing tax revenue (as it would for the federal government).

Such a sanction would not be radical in its approach. There are analogies in various federal-state "matching-grant" programs. And a most recent approach of this nature is found in the 1964 amendments

Cf. H.R. REP. No. 2681, *supra* note 16, at 215: "A sensible alternative to the imposition of the retroactive penalty described above [loss of exemption] . . . would be the immediate removal of the trustees or directors. This is primarily a matter of state law, and the Federal government could not force such removal. It could, however, we believe, provide that the retroactive penalty be assessed unless all the trustees or directors forthwith resign and arrangements are made for the election of directors appointed by a court or an agency of the state of incorporation or of the situs of the trust."

27. Another possibility would be a state regulatory agency. Karst, *supra* note 21, at 476. Fremont-Smith approves of this idea, but states: "I believe it unrealistic to expect any large number of states to create and staff such new agencies at the present." Fremont-Smith, *supra* note 21, at 62. See the views of a Texas attorney general, 1 PATMAN REPORT vi-vii.

28. The Uniform Act levies no new restrictions on foundations. Consequently, its passage would be irrelevant, for example, to the broadening of foundation management proposal.

29. This can be focused by thinking of the situation where the clear intent of the donor at the time of the creation of the foundation was that it should be managed by members of his family, whether or not this would cost the foundation its tax exemption.

to the Securities Exchange Act.[30] In applying the Act for the first time to securities other than those listed on a national exchange, a special exception was made for insurance company securities. This exception was conditioned upon the insurance companies being regulated in their state of domicile under standards similar to those set out in the Securities Exchange Act. The states were given two years to pass necessary legislation.[31] A similar method could be used for motivating state action in the foundation field.

B. *Federal Regulatory Agency*

An obvious federal approach of a non-tax nature would be the creation of a new federal regulatory agency for charitable foundations. The *Treasury Report* specifically rejects this idea:

> The Treasury Department does not, however, recommend that any separate Federal regulatory agency be created to supervise foundations. Rather, the Department is of the view that the effort should be made to frame the tax laws themselves to curb abuses.[32]

This comment was no doubt made in specific response to the proposal for such an agency made in the *Patman Report*.[33] Mr. Patman was especially interested in this proposal, as indicated by the space given it therein and by his statement that he was "especially disappointed that the Treasury turned down the idea of supervision by a special government agency."[34] Mr. Patman's strong support for such an agency, as well as calls for a *state* regulatory agency by other critics of foundations,[35] suggests that the problems involved may be too complex for effective supervision by the federal tax laws.

In discussion of a federal regulatory agency for charitable foundations, mention is often made of the British system.[36] Briefly, the Charitable Trust Acts of 1853, 1855, and 1860, created an independent board separate from the Court of Chancery, which until that time had had sole control over charitable trusts. This board, called the Charity Commissioners, has advisory and supervisory powers, subject to appeal to the Court of Chancery on quasi-judicial matters. Among the board's

30. Securities Acts Amendments of 1964, 78 Stat. 565, 15 U.S.C. 78(c) (1964).
31. Securities Exchange Act of 1934, § 12(g)(2)(G), 48 Stat. 881, as amended, 15 U.S.C. § 781(g)(2)(G) (1964).
32. TREASURY REPORT 14.
33. 1 PATMAN REPORT 134, recommendation 17(a).
34. Wall Street Journal, Feb. 9, 1965, p. 3, col. 1.
35. See note 27 *supra*.
36. The best and most comprehensive study of the English system is found in Charitable Trusts Committee, *Report*, Cmd. No. 8710 (1952) [hereinafter cited as NATHAN REPORT]. The following discussion in the text is based on the *Nathan Report*.

chief powers are the authority to require submission of annual accounts, to control dealings in land by charitable trusts, and the quasi-judicial power to make "schemes" within the cy pres doctrine.[37] An intensive study of the Charity Commissioners and charitable trusts in general was made in the early fifties by a Royal Commission. In 1952 the results of the Commission's work were published in the so-called *Nathan Report*,[38] which made the following judgment of the efficacy of the system:

> We think that the setting up of a parallel body [Charity Commissioners] to the Court of Chancery has been fully justified, and that the powers and duties conferred by the Charitable Trusts Acts, so far as they have extended, have stood the test of time. Above all, by requiring the submission of annual accounts and the consent of the Commissioners to dealings in land by charitable trustees, charitable funds have been, and are, brought into the open or at any rate much farther into the open than they were a hundred years ago. Charitable trust property has been husbanded through the control of land dealing, and by and large it seems clear that dishonest administration of charitable trusts is now almost non-existant.[39]

Does this system have any relevance for proponents of a national regulatory body for charitable foundations in this country? The following factors suggest a negative answer. In the first place, in the British unitary, non-federal system of government all functions of government are centrally controlled at the national level, whereas under our federal system such functions are split, and the regulation of charities has traditionally and constitutionally been thought to be a state matter. As a matter of politics, the creation of such an agency seems unlikely;[40] and on grounds purely of the desirability of such an agency, there is plenty of room for argument:

37. *Id.* at 25.

38. *Supra* note 36. Many of the recommendations of this report were adopted in the Charities Act of 1960, 8 & 9 Eliz. 2, e. 58.

39. NATHAN REPORT 26.

40. The Treasury Report readily admits that most foundations comply fully with the law, and that abuses are committed only by a small minority: "[M]ost private foundations act responsibly and contribute significantly to the improvement of our society. Because of the very nature of their activities and aims, precise judgment is impossible upon the extent to which foundations have realized their potentialities for creative and dynamic charitable works. It seems clear, however, that their endeavors have been conducive to important advancements in education, health, science, the arts, religion, and assistance to the needy and unfortunate." TREASURY REPORT 13. Ex-Commissioner Caplin has stated: "Based upon Internal Bevenue Service studies, the overall record of foundations emerges as a good one. Foundations as a whole stack up well against any other group of taxpayers–corporations or otherwise." Caplin, *supra* note 24, at 240.

Consequently, it may be expeeted that the guiltless foundations will be more than a little concerned with the Treasury proposals, which of course will apply as well to the innocent as to the guilty. A casual perusal of TREASURY REPORT STATEMENTS, *supra* note 22, justifies this conclusion. The pressure that foundations can generate in

I would suggest that the major drawback to the establishment of a federal agency would be the withdrawal of enforcement from the local community. Many foundations are limited by their charter to making gifts within a defined geographical area. Even if not so limited by their creating instrument, trustees and directors often make primarily local benefactions. There is an advantage, therefore, in having as supervisory officials, those who are closest to the area of the potential recipient. This is particularly true when there is a need for application of the doctrine of cy pres.[41]

C. *Criminal Penalties and Excise Tax*

Two highly specific sanctions, which might be used separately or in conjunction with other sanctions in implementing all of the proposals, are criminal penalties and a non-income tax upon the donors, trustees, etc., who perpetrate a proscribed act.[42]

In most cases criminal sanctions would be inappropriate because of the conflict between the strict requirements of proof and definition of offense in criminal cases on the one hand, and the comparatively uncertain nature of some of the conduct to be prohibited, on the other (*e.g.*, what is a "speculative" transaction, or an improper accumulation). Furthermore, there is a problem of determining what should be the exact penalty. Imprisonment seems unduly harsh in most cases.[43] A fine appears less so, but then this depends, to a large extent, upon the amount of the fine. If it is a specific amount, it will be too harsh for some and ignored by others. A fine

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opposition to the proposals is suggested in the following comment by the late Congressman B. Carroll Reece, who tilted with foundations in the investigation cited in note 16 *supra* and accompanying text: "The obstacles were obvious from the first. We knew that the influential 'liberal' press, characterized by the *New York Times*, the *New York Herald Tribune*, and the *Washington Post-Times Herald*, would throw its editorial power against the Committee. We knew that even the bulk of the conservative press could not be unmindful of the enormous power of these foundations. We knew that many prominent educators, regardless of what they felt, could not be unmindful of the dependency of their institutions upon continued largess from the foundations involved. We knew that the group of prominent men whose decisions would have to be judged extended even to intimates of the White House." Reece, *Preface* to WORMSER, FONDATIONS: THEIR POWER AND INFLUENCE at v (1958).

41. Fremont-Smith, *supra* note 21, at 91-92.

42. Mr. Patman has indicated an interest in direct penalties on foundation officials, donors, etc.: "Q. [Written questions submitted to Commissioner Caplin] Under the code, are trustees of a tax-exempt foundation subject to any personal penalty, if they engage in prohibited transactions? A. The code makes no provision for imposing a personal penalty against a trustee or trustees of a tax-exempt foundation if it engages in a prohibited transaction." 1 PATMAN REPORT 73. However, his "recommendations," *id.* at 133-35, do not include a proposal for such sanctions.

43. The *Treasury Report* itself suggests that in some cases, at least, criminal penalties are unduly harsh: "Under present law, the willful failure to file any return required by law is a criminal offense. The penalty provided is imprisonment not exceeding 1 year and a fine not exceeding $10,000. This criminal penalty is the only sanction available in cases involving the failure to file foundation information returns. Plainly, its severity makes it inappropriate in most such cases." TREASURY REPORT 64.

might be set up on a sliding scale, but then the question of the basis for the sliding scale arises (*e.g.*, a fine of one hundred per cent of the benefits of self-dealing, or five per cent of a foundation's improperly accumulated earnings).[44] And finally, whatever the specific penalty, consideration must be given to whether such penalty could be enforced. Charitable trustees, donors, etc., are almost by definition the "pillars of the community." Assuming that the federal government would be willing to label such persons as "criminals," there is doubt that their fellow citizens and erstwhile beneficiaries would care to convict.[45] And all the more so where the crime is some vague offense labelled, for example, as "undue delay in benefit to charity," or some crime in which the public can see no moral wrong, such as borrowing for investment or retaining control beyond the twenty-five year cut-off.

In some cases a non-income tax, similar to an excise tax,[46] upon trustees, donors, etc., would avoid many of the disadvantages of criminal penalties while having roughly the same effect as a criminal fine. For example, an "occupational tax" of appropriate severity might be levied on those donor-related trustees who refuse to give up their positions after twenty-five years. Or a "privilege tax" could be levied on the proceeds from speculative transactions by foundations. Again, such a tax would have to be carefully constructed so as to compel compliance by the wealthy as well as the not-so-wealthy trustee or donor. Perhaps a simple way out of this dilemma would be the imposition of a prohibitively high excise tax on the donor or foundation official for participating in proscribed activity, with power in the Commissioner to determine where to impose the tax. Such a sanction would be similar[47] to that of the present law, which the Treasury feels is ineffective. However, the *Treasury Report* proposals would eliminate the vague standards of the present law and this, coupled with the limited and specific penalty of an excise tax, might make such a sanction desirable.

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44. *Cf.* the fine suggested, *id.* at 63.

45. The following point made by Professor Karst *re* enforcement of *civil* sanctions is *a fortiori* applicable to criminal penalties: "These are the same standards which apply to the private trustee, and yet it is generally assumed (though it is beyond proving or disproving) that enforcement of the duty of care against charitable trustees has been less strict than against private trustees. Part of the reason may be that the public does, indeed, owe its gratitude to men who, usually without pay, devote their efforts to managing charitable works." Karst, *supra* note 21, at 460. See, however, the apparently successful criminal penalties used in Ontario for divesting charities of business interests, text accompanying notes 91-92, *infra*.

46. Precedents for sueh a tax are found in subtitle D of the Code.

47. In the sense that under present law it is up to the Commissioner to determine whether one of the standards of sections 503 and 504 have been violated. Because these standards are broad and rather vague, the Commissioner has considerable latitude in deciding what actions must be prosecuted.

D. *Existing Sanctions*

The sanctions for the present laws applicable to charitable foundations are loss of exemption to the foundation and denial of deduction to persons contributing to such foundations (hereinafter sometimes referred to as "existing sanctions"). This paper has as a basic assumption that these sanctions will not necessarily be exclusively applied as the sole sanctions for enforcement of all the proposals.[48] Although in some cases these sanctions may be necessary, in many other cases they will be too harsh, or ineffective,[49] and the result will be a net loss to charity. Consequently, wherever possible the best policy would be to tailor the sanction to the abuse. This approach was first adopted in the 1950 amendments,[50] which allowed foundations to retain their exemption and deduction privileges while at the same time taxing their unrelated business income. Such a view seems also to be shared by the Treasury, for a footnote to the *Treasury Report* states:

> The provisions designed to insure compliance with existing law will have to be reexamined to determine their adequacy to the task of securing compliance with the rules proposed in this Report. The fundamental objective of such provisions should be to make certain that funds which have been committed to charity and for which tax benefits have been granted will in fact be devoted to charitable ends.[51]

It should be noted at this point that loss of exemption and denial of deduction are not by their nature interdependent, and either could be used alone. Or some new combination of the two might be desirable, such as a temporary revocation of a foundation's exemption for minor or inadvertent violations without a denial of deduction for future contributions. Loss of deduction might follow later upon refusal to terminate violations of a continuing nature (*e.g.*, one donor-controlled member too many on the foundation's governing board).

Some support for the exclusive use of the existing sanctions in implementing the Treasury proposals is found in the Canadian tax laws. Our neighbors to the north already have in their law relating

48. However, since these sanctions are used exclusively (except in the limited case of unrelated business income) at the present time, some consideration of them will be found in the discussion of the specific proposals. The discussion of the existing sanctions at this point is generally applicable to all the proposals.

49. "But what happens after tax-exemption is lost? The same individuals who have been managing the funds remain in control. If they have been realizing personal profits, they may continue to do so. Perhaps the amount of profit will be reduced or eliminated, and they may no longer be able to increase the charitable endowment while enjoying a personal tax savings." Fremont-Smith, *supra* note 26, at 225. See Secretary Dillon's comment on loss of exemption as a sanction for improper accumulations, *infra* note 81.

50. See note 14 *supra* and accompanying text.

51. Treasury Report 3 n.9.

to charitable foundations provisions similar to some of the proposals made in the *Treasury Report.*[52] The sole sanctions for these provisions are loss of exemption and denial of deduction. The use of, and apparent satisfaction with, these sanctions in a country having a similar legal heritage and tax law (at least as to foundations), at the least gives one pause in suggesting the complete inapplicability here of these sanctions.

E. *Injunction*

A very good sanction might be the use of the injunction and the federal courts' contempt power.[53] This tool, or at least the threat of it, has been used with success in other areas of federal law, most notable the labor law-unfair labor practices field, to insure compliance with the law. An injunction obviously would be a flexible instrument in that the amount of the penalty could range from fines of any amount to imprisonment, and the penalty could be levied on the foundation or on the individuals, depending upon whom the party at fault was determined to be. A preliminary administrative hearing, similar to that found in the labor law area, could be used to determine the existence of the proscribed act, followed by resort to the federal courts upon a failure to comply with any order thereof. This sanction would be most effective in cases of a continuing violation, such as a foundation's failure to divest itself of control of a business, or the refusal of a donor-controlled foundation official to resign after twenty-five years.

Before passing to a consideration of specific sanctions for each proposal, it must be noted that every conceivable sanction is not discussed in regard to each proposal. In some cases this omission represents a judgment that the sanction omitted has insufficient merit in relation to the proposal in question to require discussion; in other

52. Unless the following requirements of the Canadian Income Tax Act are met, a Canadian charity, including charitable foundations, will lose its tax exemption: (1) Not less than 90% of the charity's income for the exempt period must be either distributed to some other exempt organization or used by the charity "in respect of charitable activities" of its own. Secs. 62(1)(*f*)(iii), (*g*)(iii). (2) The charity can have no outstanding debts except those arising "in respect of salaries, rents and other current operating expenses. Secs. 62(1)(*f*)(ii), (*g*)(ii). This apparently would prevent any borrowing for investment. (3) The charity cannot be in control of any other corporation (other than one given to it). Control is defined as 50% of "issued share capital." The loss of deduction provision is section 27(1)(*a*). For a general discussion of Canadian foundations, see McKeller, *Charitable Foundations,* 8 CAN. B.J. 7 (1965).

53. This is the method that has been used in Great Britain since 1855 to enforce the orders of the Charity Commissioners. Its use was continued under the Charities Act of 1960, 8 & 9 Eliz. 2, c. 58, § 41, despite the fact that the *Nathan Report* found it to be too cumbersome in certain cases. NATHAN REPORT 41-42.

cases the above discussion of sanctions in general justifies the omission.

III. Sanctions for Specific Proposals

A. *Self-Dealing*

Under present law (section 503), transactions between a donor and his foundation are not prohibited unless they violate certain rather vague standards which are supposed to require an arms-length relationship between the two (*e.g.*, "*adequate* consideration," "*reasonable* rate of return," "*adequate* security"). The Treasury proposal would eliminate these standards and completely prohibit all such transactions. Such a prohibition was proposed by the House in 1950, but was rejected by the Senate in favor of the present law.[54] It has subsequently been adopted in regard to transactions between a self-employed person and his pension trust (section 503(j).

Furthermore, under present law no restrictions whatever are placed upon persons other than substantial donors to, and creators of, foundations, and their relatives; and corporations controlled by such persons. The Treasury proposal would extend section 503 coverage, most notably, to officials of foundations and their relatives and officials of corporations that are substantial contributors to a foundation.

Consideration of sanctions must first be given to the existing sanctions—loss of exemption and denial of deduction—if for no other reason than that these were the sanctions proposed for the similar proposal made in 1950.[55] It is assumed that the imposition of such sanctions would be prospectively effective only, that is, no deduction or exemption for years prior to adoption of this proposal could be denied for prohibited acts committed subsequent to adoption. Otherwise due process questions under the state and federal constitutions would arise.

The disallowance of a self-dealing donor's deduction seems entirely appropriate, for he has obtained the deduction and its tax benefits on the assumption that his gift would thenceforth be used solely for charitable purposes. Such disallowance would probably have to be made retroactive (*i.e.*, for any contributions made after adoption of the proposal but prior to, as well as after, the self-dealing transaction) in order to control those donors who make only one contribution to a foundation; otherwise such donors, having made and received a tax benefit for an untouchable past contribution, would not be inhibited in their self-dealing activity. One modification of the

54. S. Rep. No. 2375, *supra* note 14, at 36-38.

55. *Ibid.* Secretary Dillon's comment in note 81 *infra* indicates that the loss of exemption sanction may be out of favor with the Treasury *re* self-dealing.

sanction would be to deny the deduction only to the extent that the tax benefit received therefrom equalled the benefit received in the self-dealing. This modification would make the sanction less harsh than an absolute denial in that all past deductions would not be denied because of minor benefits obtained by self-dealing; but potential self-dealers would not be encouraged because of the prospect of losing all the benefits of such self-dealing. In like manner, future deductions could be allowed to self-dealing donors once the prohibited benefit has been compensated for by loss of charitable deductions on future contributions.[56]

The desirability of denying the foundation's exemption, however, is not so clear. On its face, such a sanction seems logical, for the exemption is given only on the assumption that all the foundation's benefits will go to charity. On the other hand, unless the foundation is already contributing nothing to charity, the sanction usually results in a loss to charity, through the diversion of part of its income to the government as taxes. An argument can be made that this short-run loss to charity is compensated for by the eventual redistribution of the funds by the government. However, the basic philosophy of governmental favoritism of private charity is that there are some things that private charity can do which the government cannot do, or cannot do as effectively or efficiently. An obvious example is the case of a foundation contributing most of its funds to religious activities. The tax the government would receive on loss of the foundation's exemption could never be redistributed to religious activities in the same fashion as the foundation's allocation, if for no other reason than the constitutional prohibitions. Less obvious examples abound in charitable programs which are too controversial or speculative for government support. In all these cases it would seem that if the foundation's contribution to charity is substantial, the applicable sanction should be restricted to curing the specific abuse. In many cases loss of exemption would have a much broader effect.

In addition, loss of exemption would not be effective in certain cases: (1) If the foundation is willing to pay the tax. This situation might arise where a controlling donor set up a foundation with the secret intent to use it for his own purposes, hoping to obtain and retain the exemption but willing to pay the tax if necessary. (2) If the

56. This modification would resolve some of the "tainting" problems pointed out in the following quotation: "Must a foundation know all of the relationships, direct and indirect, of every donor no matter how small his donation? Must it before accepting a donation make sure that the donor had no transactions, or is not related to any person who had a transaction, with the foundation? How long must it keep records for this purpose? How long will the taint of being a donor or related to a donor prevent a person from dealing with a foundation?" Sugarman, 1 TREASURY REPORT STATEMENTS 471.

foundation has insufficient assets to pay the tax. The lack of assets might arise out of self-dealing transactions. (3) If the foundation has no income.

On the other hand, loss of exemption would have some deterrent effect in at least two situations. For the first, it must be remembered that the self-dealing proposal would extend the coverage of section 503 to several groups which may be composed of non-donors (*e.g.*, officials of foundations and contributing corporations). In such cases, a denial of deduction sanction would be irrelevant, whereas loss of exemption might have some deterrent effect: diminution of the foundation's income through tax payments reduces the power and prestige of the foundation, and may also result in reduction of funds available for foundation officials' salaries.[57] The second case is that of a controlling donor to whom the advantages of self-dealing with a tax-exempt organization outweigh the potential loss of deduction.[58] Under such circumstances, the threat of loss of exemption has a force not obtainable solely by denial of deduction.

While denial of deduction and loss of exemption do not necessarily have to be combined as sanctions as under present law, the above discussion suggests that if no other sanctions are employed, each of the existing sanctions is a necessary complement to the other. Of course, some combination of one of these sanctions with some other sanction might prove effective, such as denial of deduction to donors and an excise tax or criminal fine on non-donors. If, however, the two existing sanctions alone are continued as the sole sanctions for self-dealing, the following proposal made by one commentator prior to the issuance of the *Treasury Report* seems an applicable and appropriate solution to the problem:

> As a general rule, the retroactive denial of exemption *and the donor's deduction* should follow whenever the donor (or a related person . . .) engages in a prohibited transaction, without reference to the donor's state of mind at the time of his donation. Of course there will be cases in which this sanction will be too extreme; some prohibited transactions will surely be inadvertent, and retroactive sanctions will be too severe. As an escape valve, the Commissioner should have the power to withhold the retroactive sanctions when he determines (i) that the prohibited transaction was inadvertent, and (ii) that to deny exemption and deduction retroactively would cause undue hardship. In order to avoid manipulation of the general three-year limitations period, a special long period of limitation should be established for cases of retroactive denial of exemption and deductions under

57. *Cf.* Fremont-Smith, *supra* note 26.

58. A donor might be quite willing to forego the deduction in return for the privilege of dealing with the income from his former assets, income which will now be greatly increased because of the foundation's exemption.

this section. Ten years might be an appropriate period, with a no-limitation exception for cases of fraud.[59]

If, in this excerpt, all parties covered under the Treasury's self-dealing proposal are substituted for "donors," and if the Treasury is also given the power to withhold the sanction upon finding that a serious loss to charity might result, this proposal makes good use of the existing sanctions. Such a combination of the sanctions has desirable attributes in that it is completely retroactive, would be costly to self-dealing donors, and yet is selective in nature through delegation to the Commissioner of a broad discretionary power. Of course, it would not prove effective in all cases, such as that of the non-donor self-dealer. This defect, however, is due to the limitations of the sanctions employed and not to the proposal.

Two other sanctions which might be used in lieu of, or in combination with, the existing sanctions are allocation of the foundation's tax liability, or its income, to the self-dealer. The following interesting proposal has been made in regard to the former:

> If a foundation loses its exemption because it has participated in a prohibited transaction with a donor, a member of his family (as defined) or a corporation controlled by him (as defined), the donor shall be liable for the tax payable by the foundation to the extent that taxes otherwise payable by him were avoided by reason of deductions taken by him for gifts to the foundation, with interest on the amount of the taxes thus avoided at the rate of 6% from the dates on which the earliest taxes thus avoided were payable.
>
> If the donor fails to discharge the foundation's tax liability to the extent indicated, the foundation shall be liable therefor, but, upon discharging that liability, it shall have a cause of action therefor against the donor, any provision of state law, any provision of the trust or corporate instrument creating the trust, or any agreement between the donor and the foundation to the contrary notwithstanding. Failure to enforce this cause of action shall constitute a breach of trust for which each member of the foundation's board of trustees or board of directors shall be severally liable, and the Attorney General of the state in which the trust is administered, or his delegate, shall be entitled to enforce this liability.[60]

An obvious purpose of this proposal, which attempts to shift the tax burden from the foundation to the self-dealer, is the protection of the charitable functions of the foundation. The proposal, however, assumes an alert state official who can and will know of any breach of

59. Karst, *The Tax Exemption of Donor-Controlled Foundations,* 25 OHIO ST. L.J. 183, 204 (1964).

60. Proposal submitted by Professor David F. Cavers to his Trusts class, Harvard Law School, March 31, 1965.

duty on the part of the foundation's officials; as pointed out above,[61] such assumption may not be well-grounded. Consequently, it would seem that unless some method is provided by which the appropriate state officials are made aware of the breach of duty of foundation officials for failure to prosecute the proposed cause of action, the foundation will still bear the brunt of the tax. One possible solution would be automatic notification of state officials by the federal government whenever the foundation's exemption is lost.[62]

Assuming the notification obstacle can be surmounted, this sanction is palatable because it taxes the party responsible for the imposition of the tax. One minor inconsistency would be that the tax attributable to the self-dealer would vary for the same amount of income depending upon whether the foundation was organized as a trust or a corporation.[63] The self-dealer should not be heard to complain on this count, however, for he will no doubt be fully aware of the breed of organization with which he is self-dealing.

Otherwise, this proposal seems more free from defect than any other sanction in an area where no one sanction can be perfect. The suggestion that the foundation have a cause of action against the donor, in the event the foundation pays the tax, finds precedent in section 2205, relating to reimbursement of estate beneficiaries who have borne more than their rightful share of the estate tax burden. It is doubtful, on the other hand, that section 503 should determine what is or is not a breach of trust, but failure to enforce the cause of action would probably be a breach of trust under existing state law.

A somewhat analogous approach would be attribution of the foundation's income to the self-dealing donor. The tax paid would not vary with the form of the organization,[64] as in the attribution of tax sanction discussed above, but the tax would vary with the marginal tax bracket of the self-dealer, and would be at the individual, rather than the corporate, tax rate. A prime question here is what should be the outer limits of the income attributed. It would seem harsh in some cases to attribute the entire income of a foundation to the self-dealer. Perhaps the amount of the attributable income should not exceed the amount

61. See text accompanying note 23 *supra.*

62. On a broader scale, the New York State Bar Association Section on Taxation recommends: "To encourage the enforcement at the State level, the Internal Revenue Service might be permitted to notify the appropriate State authorities of any irregularity discovered in audit and to furnish such information as it has to aid the State in enforcement of State remedies." 2 Treasury Report Statements 713.

63. That is, a foundation organized as a trust would be taxed at normal rates and a foundation organized as a corporation could be taxed at corporate rates. This distinction is now made for the unrelated business income of foundations, Int. Rev. Code of 1954, § 511(a), (b).

64. Because it is the income, not the tax, that is being attributed.

of past or future deductions taken for contributions to the foundation. This method would produce a different tax from the alternative sanction of attributing that amount of income which would give rise to a tax equal to the tax benefit received from the deductions. This latter alternative would produce a tax equal to that arising under the attribution of tax sanctions discussed in the preceeding paragraph. Of course the income attributed to the self-dealer would only be used for computing his tax, requiring him to produce the tax payment from other sources. In other words, a result similar to that in the Clifford Trust area.

Both these proposals are subject to the same weakness as the denial of deduction: they are only effective against a donor who has received a tax benefit in the form of a charitable deduction. For non-donors to whom section 503 will now be extended, such sanctions could be made effective only by attributing all of the foundation's income or tax to such persons,[65] unless some other appropriate method of setting the limits of the liability could be found. One limit, already suggested in discussing the use of the existing sanctions for the self-dealing proposal,[66] would be to limit the attributable tax or income to no more than the amount of the benefit received by the non-donor official from the self-dealing act. In all these cases, however, the effect of such a limitation would be to reinstitute in the *sanction* itself the vague arms-length standards which will be eliminated by this proposal from the *substantive* provision. For example, in the case of a purchase by a trustee of the property of his foundation, the prohibited activity will by definition be assumed, but the same problems as before will arise in determining the extent of the inadequacies of consideration given, if any. One solution might be to place the burden of proof upon the self-dealer to show the extent of the benefit received by the foundation in exchange for the benefit received by the self-dealer, and to allocate to him the foundation's tax or income to the extent that he could not prove an equality of benefits (up to and including all of the tax or income).[67] Of course, by limiting the sanction to the extent of the benefit received, the sanction is negated when the benefits surrendered equal the benefits received. In such

65. This sanction would be extremely harsh in many cases (*e.g.*, a foundation with $500,000 of income for the year and a self-dealing trustee of moderate means). Since no income is actually received with which to pay the tax, there would be many cases where no tax payments would result from such a sanction.

66. See text accompanying note 55 *supra.*

67. *Cf.* Hogan & Hartson, 1 TREASURY REPORT STATEMENTS 204. The presumption in favor of the Commissioner's correct assessment of the tax probably would place the burden of proof on the taxpayer without any special provision. Perhaps a stricter burden of proof (*e.g.*, "clear and convincing") should be used in these cases.

cases some further sanction, such as an excise tax or criminal penalty may be required.

Some scattered sources have suggested that an analogy can be made to the Clifford Trust provisions in imposing sanctions for self-dealing;[68] it may even be that these provisions already have some application in the charitable foundation field.[69] It must be remembered, however, that these provisions, found in subpart E of subchapter J, are applicable only to trusts; consequently, they are of no value in regulating three-fourths[70] of the charitable foundations which are organized as corporations. Furthermore, there is some question whether the provisions of subpart E are applicable at all to *charitable* trusts.[71] Of course, these problems could be remedied by changing the law if the extension of the subpart E provisions to the charitable foundation field is deemed desirable.

On the merits, it has been pointed out that if a donor retained, as a formal matter, the powers which would render him taxable under the subpart E sections, the organization would not initially qualify as a charity under section 501(c)(3).[72] Therefore, the principal effect of such sanctions at that point would be to render the donor or creator of a foundation (or other persons who have a section 678-type power) taxable on the income of the foundation.[73] The same commentator,

68. 1 PATMAN REPORT 133-34, recommendation 9; Krasnowiecki & Brodsky, *Comment on the Patman Report,* 112 U. PA. L. REV. 190, 198 (1963); *cf.* Karst, *supra* note 59, at 206-11. Although most of the discussion of Clifford Trust doctrine *re* charitable foundation centers around the problem of donor control of the foundation or a foundation-owned business, one of the major abuses of such donor control is self-dealing.

69. Another method of reallocating income which could be used as the law now is, and which presumably would be applicable to the *Treasury Report* proposals, is § 482 (the "organizations" to which § 482 applies include exempt organizations). Treas. Reg. § 1.482-1(a)-(1) (1962). Young, *Donor Foundation Dealings,* N.Y.U. 22D. INST. ON FED. TAX 971-72 (1964), points out how § 482 might be employed: "Section 482 strikes only at an improper exercise of control (resulting in misallocation of income or deductions)—*i.e.,* transactions between donors and foundations which are demonstrably not at arm's length. Insofar as the donor is attempting to milk the foundation, the particnlar abuse is probably already identified as a prohibited transaction. And there is ordinarily little to be gained by the Service in reallocating this income to the foundation. The more usual situation for the application of Section 482 involves an effort by the donor to divert income to the foundation. . . . Here the prohibited transactions rules are not an obstacle. Section 482 should be, but, in the only discovered case involving an exempt organization, its invocation was thwarted by an interpretation of the control requirement [Stevens Bros. & Miller-Hutchinson Co., 24 T.C. 953 (1955)]." Mr. Patman in one of his proposals seems to have in mind something akin to § 482 or § 532: "Exemption should be denied if a foundation has been formed or availed of for tax avoidance purposes or to get financial benefits for the contributor." 1 PATMAN REPORT 134, recommendation 10.

70. Karst, *supra* note 21, at 456.

71. *Compare* Young, *Donor Foundation Dealings, supra* note 67, at 988 *with* Krasnowiecki & Brodsky, *supra* note 68, at 196.

72. *Ibid.*

73. *Id.* at 197.

however, goes on to say that "we do not expose the shareholders of a business corporation to this treatment, and there is no reason to recommend it in this case."[74] However,

> A different situation is presented when the objectionable relationship to the foundation arises *after* the creation of the foundation or when the retained control offers a potential for securing private benefits in the future. On this point there is a vast difference in philosophy and result between the rules applicable to trusts and those applicable to the incorporated foundation.
>
> For example, it is no answer to Representative Patman's proposal that the powers listed in section 675 are for the most part covered by section 503(c). Under section 503(c) the incorporated foundation does not lose its charitable status until it has in fact conferred the prohibited benefits upon the creator. That the control retained by the creator offered a potential for this is immaterial. Charitable deductions obtained prior to the taxable year in which the exemption is lost are not recalled under section 503(e). *Even after the loss of the exemption, due to some prohibited transaction which benefits the creator, the creator does not become taxable on the income of an incorporated foundation—as he might if trust rules were applicable.*[75]

Adoption of a Clifford-type sanction would have no effect on the foundation itself. In general it would have no effect on persons other than donors and creators, except in the case of a provision like section 678. A further problem is that the Treasury proposal contemplates no self-dealing at all between donor and foundation: the Clifford sections allow such activity in limited cases where an "adverse party" or person not "related or subordinate" has the right to pass on the transaction. Consequently, some substantial modifications would have to be made in the Clifford sections to fit them to the Treasury proposal. On the other hand, the proposal itself might be modified so as to allow self-dealing in such limited cases. A difficulty would arise here in finding an "adverse party," for by definition there can be no direct beneficiary of a charitable organization.[76] A representative of the state, which has the most interest in charitable organizations, might suffice,[77] but such an approach would require the filling of 15,000

74. *Ibid.*

75. *Id.* at 197-98 (Emphasis added.)

76. "The latter definition ["adverse party"] will be of no use to us in dealing with the problem of controlled foundations; ordinarily, the only person with a "substantial beneficial interest" in the funds and operations of a foundation is the attorney general of the state on behalf of the public." Karst, *supra* note 59, at 207.

77. "The suggestion has been made that each foundation should be required to have, upon its board, or as one of its trustees, a member selected by a government agency, perhaps the state government. The purpose of the suggestion is that the public would thus have a direct representative who could watch the operations of the foundation and take whatever action he might deem necessary if he found a violation of good practice or of law. The suggestion may have merit. . . ." H.R. Rep. No. 2681, 83d Cong., 2d Sess. 215-16 (1954). See generally Karst, *supra* note 59, at 207-08.

positions, and would inject an outside party into many of the affairs of foundations which have nothing whatever to do with donor-foundation relations. Alternatively, the "related or subordinate" test could be relied upon exclusively, but past experience in the non-charitable trust area has revealed serious defects in this requirement.[78]

In sum, it may be said that the Clifford provisions themselves are not particularly suited for importation into the charitable foundation area. On the other hand, the underlying principle of these provisions, the taxation of the donor of a trust on his trust income in certain circumstances, has merit, and is discussed separately above.[79]

B. *Delay in Benefit to Charity*

Congress for some time has been concerned with the problem of improper accumulations of income by foundations. The House version of the Revenue Act of 1950 would generally have taxed that portion of an organization's income (excluding capital gains and contributions) which the organization did not currently distribute for charitable purposes. This provision was rejected by the Senate in favor of the present section 504.[80] Section 504 prohibits accumulations which violate certain standards (*e.g.*, "unreasonable in amount"), and creates a negative implication that some kinds of accumulations may be proper. The Treasury, in justifying the new proposal, contends that the uncertain scope of these standards and judicial interpretation of them have combined to make section 504 difficult to administer.

The discussion of existing sanctions in the self-dealing section of this paper is generally applicable here.[81] One point that should be

78. "Estate planners seldom have difficulty in finding 'independent' trustees who are perfectly willing to do what the grantor of a 'Clifford' trust wants them to do. In the foundation context, there is no reason to believe that the situation would be different. Then is the answer to be found in a broadened definition of 'related or subordinate parties'? Probably not. It is doubtful whether any such definition could succeed, in view of the infinite number of possibilities for finding subservient directors who have no formal connections with the donor. . . ." Karst, *supra* note 59, at 207.

79. See text accompanying note 64 *supra*.

80. S. REP. No. 2375, 81st Cong., 2d Sess. 33-35 (1950). The Senate substituted the disclosure provisions therefor: "Your committee has rejected this accumulations tax and substituted for it the requirement that information disclosing the extent of accumulations must be made available to the public. Your committee does not question the contention that some organizations are abusing their tax-exempt privilege by undesirable accumulations of income. However, witnesses before, and statements presented to your committee brought out quite clearly that the measure passed by the House was too inflexible and as a result would seriously injure many worthwhile educational and charitable projects. . . . It is believed that publishing information about the accumulations of these foundations and trusts will serve two purposes. First, full public information will encourage distributions. Second, it will reveal the extent of the accumulations problem." *Id.* at 34-35.

81. The Treasury apparently feels that the loss of exemption sanction is too

noted is that the loss here of the foundation's exemption will result in taxation of that portion of the foundation's income, albeit small, distributed to charity.

A more appropriate sanction would be a tax to the foundation on that portion of its income which is not distributed, or, in the case of unreasonably low rate of return from assets, a tax to the foundation on the difference between what is earned (assuming this is distributed) and what should have been earned. In either case capital gains would be excluded. Such a sanction would be similar to that proposed by the House in 1950. Two variations of this sanction which might be thought desirable would be the elimination of the difference in tax treatment depending on the form of organization of the foundation, and an increased rate of tax for every year of non-compliance. In any event, one questionable effect of this sanction is that in the case of an unreasonably low rate of return an imputed income which was never received would be taxed, thereby often[82] requiring payment of the tax out of corpus.[83] In such a case a conflict might arise between the requirements of federal law and the terms of either the foundation's charter or trust instrument or state law.

The following sanction, which would avoid this problem, could be substituted for the last-discussed sanction in such cases: A basis would be established (*e.g.*, the amount of the donor's deduction or the fair market value of an acquired asset at the time of acquisition) for the unproductive assets, which would be reduced annually by the amount of the income which should have been earned, and the foundation would be taxed upon the sale of those assets to the extent of the difference between original basis and the basis at the time of

strict for the self-dealing and unreasonable accumulations area: "In all likelihood, however, such a transaction would be a prohibited transaction, the penalty for which is loss of the foundation's exception. That is one area I mentioned the need to study, where the penalties may be too strict. . . . [T]he courts have been very reluctant to ever impose that penalty which presumably they found too strong, so the Treasury has been eminently unsuccessful in legal cases in the courts in this area. We think some sort of a different penalty there, maybe a penalty to tax certain accumulations that are not distributed, would be much more likely to be effective than the present situation. This may apply in this area [prohibited transactions] that you are talking of, too." PATMAN HEARING 20 (Secretary Dillon).

82. In some cases the return on the asset, even though below the required percentage, will be of an amount sufficient to pay the tax on the imputed income, thereby requiring no payment out of corpus. For example, if the required percentage of return is set at 3%, and a foundation asset worth $100,000 returns only $1,000 in income, this would be sufficient to pay the tax on the $2,000 of imputed income if the rate of the tax is 50%.

83. A foundation probably would not be able to borrow the money to pay the tax if the proposal regarding foundation borrowing for investment is adopted. Note that Secretary Dillon's suggestion in note 81 *supra* for a tax to the foundation on accumulations may be limited to amounts actually received.

sale.[84] Such a sanction would be consistent with the Treasury's view that a foundation's use of low-income assets is often motivated by a desire for capital appreciation, for such appreciation is often accompanied by, and to some extent created by, a low rate of return on the asset (*e.g.*, retention of corporate earnings in order to promote expansion). Such sanction, however, would lapse when the cumulative amount of imputed income finally exceeds the basis.

The above sanctions will be subject to avoidance, however, unless some provision is made for denying to the foundation the benefit of having a controlled corporation accumulate its income.[85] Under present law, as the Treasury points out,

> The restrictions . . . upon accumulations of income by businesses become operative only where a corporation is 'formed or availed of for the purpose of avoiding the income tax with respect to its shareholders [sec. 532]'; where shareholders of the business are themselves tax exempt, the limitations may not apply.[86]

It could be argued that with adoption of a new anti-accumulation law such as this proposal, with a sanction that taxes the foundation on the income which it improperly accumulates, the courts might be inclined to find section 532 to be applicable to businesses having exempt shareholders, for the accumulation of income by the business would usually be for the purpose of avoiding the tax to the business's

84. For example, a donor contributes to the foundation stock having a fair market value of $100,000, or the foundation acquires such stock with its own funds. The foundation holds the stock for fifteen years, aud receives $1,000 of income on the stock in each of those years. In the fifteenth year the stock suddenly appreciates in value, and the foundation sells it for $150,000. Assuming the required rate of return to be the maximum suggested by the Treasury, 3½%, the imputed income for each year would be $2,500, thereby reducing the stock's basis to $62,500 after fifteen years. The amount of the tax on the $37,500, determined by subtracting the sale basis from the original basis, would be $18,750, assuming a 50% tax rate. Note that this amount exceeds the $15,000 actually received by the foundation during the fifteen years, and would have required tax payments out of corpus if paid in those years. Even under this approach tax payments would have to come out of corpus if at the time of sale the asset has not appreciated sufficiently in value (in the above example, at least $18,750), or if the asset is sold at a loss. In such cases an exception could be made for the amount of tax which would have to be paid out of corpus. Of course, if the asset is not sold this sanction will have no effect.

85. The foundation could increase the value of its stock in the controlled corporation, to charity's detriment, if the rate of return on the investment in the corporation was higher than 3.5%, by directing the corporation to pay out no more than 3.5%. It should be remembered here that the Treasury proposes to have a foundation pay out *all* of its income, and that the 3.5% limit is merely the minimum allowable return. If a foundation can restrict the income from its controlled corporation to the bare minimum, the requirement that the foundation pay out all of its income to charity will be partially ineffective in preventing undue delay in benefit to charity. If the excess of income over 3.5% is retained in the corporation for valid business reasons (*cf.* § 532 of the Code), there is no cause for concern.

86. TREASURY REPORT 34.

shareholder, the foundation. However, section 504 now has the indirect effect of making the foundation taxable on its income by denial of its exemption, and yet the Treasury implies that additional legislation is needed. So perhaps the best solution would be an amendment to section 532 making it applicable to businesses owned by foundations.[87]

An alternative approach which could have prospective effect only would be a refusal by the Treasury to grant an exemption to a new foundation unless the foundation's charter contains a provision requiring distribution currently of the prescribed percentage of its assets for charity. Such a provision would induce foundation officials to invest in assets with a reasonable rate of return and would open the way for state action in the event such officials failed to comply with their charter.

C. *Foundation Involvement in Business*

The third proposal of the Treasury Report breaks new ground, for there is no law at present restricting foundation ownership of a business.[88] Previous discussion of the loss of exemption sanction has application here. Loss of exemption would be especially effective in the case of a foundation having varied business holdings, some of which exceed the twenty per cent control limitation: loss of exemption would mean not only the taxation of the income from the offending stock, but also the taxation of the income from all other business holdings. Consequently, such foundations subject to this sanction might be quite willing to meet the twenty per cent test in order to protect the income of their other holdings.

A criminal penalty of some sort seems more appropriate for this proposal than for most of the others. For example, a fine of a specific amount might be levied for each day of non-compliance.[89] The problems of criminal sanctions discussed above are less serious here than in other areas, for the proof and definition of offense difficulties inherent in criminal sanctions, are not as crucial, due to the limited and specific

87. Mr. Patman also recommended this sanction, 1 PATMAN REPORT 134, recommendation 15. The Treasury's objection to this sanction is not overly persuasive: "Even if the accumulation restrictions of existing law were extended to these situations, their enforcement would require an arduous, case-by-case examination of each separate set of facts." TREASURY REPORT 34 n.21. Mr. Patman also suggested the following interesting sanction, reminiscent of Clifford Trust doctrine: "For the purpose of computing the accumulation of income, amounts unreasonably accumulated in corporations controlled by a foundation should be added to the fouudation's direct accumulation as if the two were one." 1 PATMAN REPORT 134, recommendation 14.

88. Other than the requirement under § 501 that the running of the business not be the primary function of the foundation.

89. *Cf.* TREASURY REPORT 64.

nature of the offense (*i.e.*, the retention by a foundation of twenty per cent or more of the voting control or equity in a business). In addition, the proscribed act here has anti-trust-unfair competition overtones,[90] for which there is precedent for criminal penalties.

Some support for the use of criminal penalties in securing divestiture of the excess stock is found in the Charitable Gifts Act of Ontario. Under this Act, whenever a business operated for profit is given to any "person," including charitable foundations, such person must dispose of all but a ten per cent interest in the business.[91] The sanctions for failure to comply with the Act are a fine of 100 to 5,000 dollars, imprisonment for not more than one year, or both.[92] The value of this example as support for use of criminal sanctions in this area is somewhat lessened by the fact that the Act is not a tax statute and has not been enacted at the national level in Canada.

A more appropriate sanction here, it would seem, would be to tax the foundation on the income or rent from the excess stock[93] or property (the foundation would already be taxable under present law on the income from unincorporated *business* assets it controls which are unrelated to its exempt function). The obvious precedent for such a sanction is the present treatment of unrelated business income under sections 511-15. In fact, one method of imposing the sanction would be the elimination of the exception for dividends found in section 512(b)(1) for stock held in excess of the percentage limitation.[94]

This approach would go far toward reducing the competitive

90. See TREASURY REPORT 31-34; 1 PATMAN REPORT 9-18; *Patman Hearings* 5, 16, 58.

91. Ont. Stat. 1959, c. 50, § 2.

92. Ont. Stat. 1959, c. 50, § 9.

93. "If divestiture legislation is enacted, the committee believes that an appropriate sanction for this type of legislation would be the imposition of a tax on the income which a foundation derives from stockholdings exceeding the prescribed limit. Thus, if a foundation owned all of the outstanding stock of a business unrelated to its charitable activities after the permissive time for divestiture, the business would be taxed at the normal corporate rates and, in addition, the foundation would be taxed on the income received from the stock in excess of the prescribed limit. The rate of the foundation's tax would be determined on a graduated scale, increasing with each succeeding year of non-compliance." New York State Bar Association Section on Taxation, 2 TREASURY REPORT STATEMENTS 724.

94. The following recommendation by Mr. Patman can be interpreted as suggesting this sanction: "Tax-exempt foundations should be prohibited from engaging in business directly or indirectly. Foundations controlling corporations engaged in business, through the extent of stock-ownership in those corporations, should themselves be deemed to be engaged in that business." 1 PATMAN REPORT 133, recommendation 2. That is, if the foundation is to be deemed to be engaged in the business of its controlled corporation, the income from the corporation would be the foundation's business income; and if the business of the corporation is unrelated to the charitable functions of the foundation, such income would be unrelated business income. See also Baker, 1 TREASURY REPORT STATEMENTS 132.

advantage foundations have over non-exempt businesses with whom they compete. The Treasury, however, is concerned with other undesirable effects of foundation control of business, such as diversion of foundation officials' time and attention to purely business matters. Consequently, a stronger application of this sanction, such as a tax rate higher than that presently applied to unrelated business income, might prove more suitable. Or the unrelated business income approach could be used in combination with additional penalties, such as denial of the intercorporate dividend deduction for such income. Under present law a foundation organized as a trust would not be affected by such denial, so the appropriateness of this penalty would be conditional on the equalization of trust and corporation tax treatment in this respect.

D. *Financial Transactions Unrelated to Charitable Functions*

The Treasury proposal relating to financial transactions is aimed at three specific abuses and calls for, it would seem, sanctions limited to the abuses. On this assumption consideration of the exclusive use of the existing sanctions is omitted.

The most direct and specific sanctions would be criminal penalties, but in this area the problems of criminal sanctions mentioned above would be present.[95] However, about the same effect could be obtained from the use of excise taxes levied on foundation officials for participating in such transactions. Such a tax could be measured by a percentage of the benefit the foundation receives from the transaction or, in order to penalize unsuccessful transactions as well, a percentage of the sums borrowed, loaned, or used for speculation. This sanction could be strengthened by increasing the rate of the tax for each subsequent violation.[96] In extreme cases, or after a certain number of violations, the foundation's exemption could be revoked.

In the alternative, the foundation itself could be taxed in the same fashion for such transactions. Or the tax could be applied by use of the unrelated business income provisions. At present, rental income from assets purchased with borrowed money is included in unrelated business income (section 514). This section could be expanded to include income from any asset (*e.g.*, securities) purchased with borrowed money, income arising out of speculative transactions, and interest from prohibited loans.[97]

95. See text accompanying notes 42-43 *supra*.

96. *Cf.* note 93 *supra*.

97. Mr. Patman suggested including in unrelated business income the income from assets purchased with borrowed funds and speculative income. 1 PATMAN REPORT 133, recommendation 8. He apparently would want an absolute ban on foundation lending, *id.* at recommendation 3.

If such a sanction is adopted, the six-month holding period for capital gains treatment apparently would be, or at any rate could be, made applicable to profits from speculative transactions. The sanction could be strengthened by lengthening this period for foundation transactions, or by taxing all such profits at ordinary rates without regard to the holding period.[98] In order to discourage a "what have we to lose" attitude as to speculative transactions, a penalty, such as a tax of a percentage of the value of the assets, sums, etc., employed in the speculative transactions, should be levied on unsuccessful transactions.[99]

An even more effective, self-enforcing sanction of a non-tax nature could be employed in regard to speculative transactions. The party who buys from, or sells to, the charitable foundation could be given the right to sue in any court of competent jurisdiction to recover the consideration paid for the property in cases of a sale by the foundation, or to recover the property itself in cases of purchases by the foundation, with interest or rent thereon as the case may be. A party bringing this action would be required to tender back to the foundation whatever he had initially received from it. In other words, a statutory form of equitable rescission would be authorized. This sanction would be self-policing in that any profit accruing to the foundation through speculative practices could be, and presumably would be, recovered by the party dealing with the foundation. No further sanction for unsuccessful transactions would seem necessary since the elimination of any chance for profit would no doubt be a sufficiently strong deterrent.

Such a sanction imposed at the federal level would not be without precedent, for this is essentially what is done under the Securities Act to discourage improper sales of securities.[100] However, since speculative transactions by foundation officials are already regulated to some extent by state law of fiduciaries, it may be desirable to have this proposal adopted at the state level. This could be encouraged by imposing the existing sanctions on such transactions in states not having such a law, as described in greater detail above.

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98. The suggestion has been made that capital gains treatment be conditioned on the *frequency* of short-term transactions, rather than on a holding period. This would allow a foundation to reduce its losses by a quick sale, if necessary, but would penalize an excessive number of short-term transactions. Hogan & Hartson, 1 Treasury Report Statements 222.

99. Otherwise foundation officials with a speculative propensity would be encouraged to engage in the riskiest kinds of transactions, transactions certain either to provide a profit in an amount to nullify the tax sanction or to result in a loss not penalized.

100. Securities Act of 1933, § 12, 48 Stat. 74, 15 U.S.C. § 771 (1964).

E. *Broadening of Foundation Management*

The Treasury's proposal for broadening foundation management may be the most controversial of the lot. In proposing that donor control over foundations be twenty-five per cent after twenty-five years, the Treasury has three objectives in mind: the prevention of subtle forms of self-dealing between donor and foundation, the elimination of socially useless foundations, and the infusion of new blood into foundation management.

Loss of exemption would be less appropriate here than in any other area, for in the vast majority of cases the foundation, even if improperly controlled, will be performing some substantial charitable function. This charitable function may be socially desirable and worth the cost of the exemption, and loss of exemption then would detract from the performance of that function. The Treasury here is not making a judgment that a foundation loses its usefulness after twenty-five years if controlled by the donor, but rather that after twenty-five years some person independent of the donor who is also committed to the foundation should review the purposes and performance of the foundation. Loss of exemption would cut the heart out of the foundation when only a physical examination is prescribed. As for the donor's deduction, prospective denial of it here, as in other cases, would be ineffective where the donor has no further contribution in mind. Denial of the deduction retroactively would be unfair, since at the time the past deduction was made the donor had every right to make the contribution.

It would seem that the best sanction here would be one that operates directly on the offending trustees. An occupational tax for such officials has already been mentioned.[101] Criminal penalties would have a direct effect, but are subject to some of the problems already mentioned.[102] Earlier discussion of the use of injunctive proceedings in the federal courts is applicable here.[103]

Other more radical sanctions could be applied. The foundation could be terminated upon a failure of the offending officials to resign, or new officials could be permanently appointed by a government body to replace old officials. A government agency could be given power to exercise the offending officials' vote until such officials terminate their positions.

None of these sanctions, either tax sanctions or others, would appear quite as extreme if enacted at the state level. Since the federal tax interest is hardest to define or justify in this proposal because of the

101. See text accompaning note 46 *supra.*
102. See text accompanying note 43 *supra.*
103. See text accompanying note 53 *supra.*

subtleness of the abuses intended to be counteracted, this proposal, more than others, should be adopted at the state level. The above discussion of methods for encouraging state action would apply here.[104]

IV. CONCLUSION

Though most of this paper has consisted of conclusions as to what sanctions are applicable and appropriate, some more general conclusions can be stated here:

In many cases the choice of sanctions will depend upon what it sought to be accomplished. For some proposals, it may be enough merely to impose a sanction which places a burden on otherwise legitimate activity, in order to secure voluntary compliance. For others, the desirable sanction may be one that imposes an absolute ban on the proscribed activity, either by making that activity illegal or by some affirmative act on the part of the government to secure compliance. To illustrate, the present sanctions for self-dealing do not prohibit such activity, but rather make it costly by imposing a tax. Such a sanction, perhaps modified by attributing the tax to the party at fault, as described above,[105] would not seem inappropriate for use with the new self-dealing proposal. Likewise, in the financial transactions area, an extension of the unrelated business income provisions would be analogous. On the other hand, the Treasury seems interested in securing complete compliance in the broadening of foundation management and foundation involvement in business areas. Perhaps this is due to the difficulties in defining and proving the abuses and special benefits that result from such activity, and to the fact that a less stringent sanction might prove ineffective or inordinately harmful to charity. Consequently a sanction likely to compel complete compliance (*e.g.*, injunction, criminal penalty, confiscatory tax) would seem most appropriate.

Part of the problem in determining appropriate sanctions is that the Treasury proposals are not limited to abuses which have a clearly defined impact upon the federal tax laws and revenues. Rather, the proposals must be viewed realistically as a call for wide reform in the charitable foundation field, a reform which in many cases will have an incidental, though perhaps important, effect on the federal tax interest. Consequently, before a choice of sanctions is attempted, a considered judgment must be made whether the proposals themselves are appropriate for imposition by the federal government. Without

104. See text accompanying notes 26-31 *supra*. *Cf.* the Reece Committee suggestion, H.R. REP. No. 2681, *supra* note 77.

105. See text accompanying notes 60-63 *supra*.

straying too far from the subject of this paper, it must at least be noted that most of these proposals would not seem unusual if made at the state level.[106] From the point of view of sanctions, then, it would seem logically to follow that in the beginning sanctions should be limited to those designed to induce state action. If such sanctions fail in their purpose, then resort could be made to other sanctions.

The suggestion has been made that if the Treasury's primary purpose in making the proposals is to induce compliance with the conditions of exemption, then the sanction should simply be the imposition of the tax.[107] This analysis is logically compelling, but the ill-defined role of foundations in our society and the potential harm to charity require that some of these conditions be modified or abandoned in favor of lesser sanctions than loss of exemption. Consequently, the difficult search must be made for sanctions that will effectively insure compliance with the proposal in question, and do no more. Congress' approval in 1950 of the tax exemption for a foundation having unrelated business income was recognition that full imposition of the tax does not always best serve the public interest. This same view can also serve as a starting point in the search for sanctions here. Or to put the point more musically, to say with the Mikado of Japan, let the punishment fit the crime.

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106. Professor Simon expresses the broader point most eloquently: "More generally, a decent regard for the desirable features of federalism should make us wary of relying on our federal tax system to perform jobs that might, with some extra help, be handled adequately by existing state institutions. It seems hard to say that the need for nationally uniform treatment of foundations is urgent enough to overcome such diffidence. Nor do I believe that the fact of federal tax indulgence should sweep before it all our scruples about decentralization of authority. Assuming that there is a federal revenue interest in foundation asset productivity, it is hardly exclusive of the traditional state interest and does not seem to me to justify federal absorption of the policing role." 1 TREASURY REPORT STATEMENTS 461.

107. Interview with Professor Albert M. Sacks, Harvard Law School.