Cornell Law Review

Volume 58
Issue 2 *January 1973*

Article 3

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Recommended Citation

John H. Davies, *Charitable Contributions Credit a Proposal to Replace Section 501 (c) (3) Tax-Exempt Organizations*, 58 Cornell L. Rev. 304 (1973)
Available at: http://scholarship.law.cornell.edu/clr/vol58/iss2/3

THE CHARITABLE CONTRIBUTIONS CREDIT: A PROPOSAL TO REPLACE SECTION 501(c)(3) TAX-EXEMPT ORGANIZATIONS

John H. Davies†

One might be tempted to guess that it is primarily the wealthy who take advantage of the present charitable contributions deduction. Recent statistics, however, disclose that this is not the case. In February 1972, the Treasury Department released preliminary data for 1970 individual income tax returns. According to the Department, nearly one half of the approximately $13 billion in charitable deductions were taken by taxpayers with adjusted gross incomes of less than $15,000. Even more striking was the disclosure that these lower income taxpayers paid almost the same percentage of their adjusted gross income to charity as did their more wealthy counterparts.[1]

Charitable deductions, as closely as can be estimated, cost the government at least $4 billion in 1970 individual income tax revenues.[2] It was estimated that taxable income for fiscal year 1971 lost to charitable deductions for contributions (other than to educational institutions) amounted to over $3.5 billion. The only tax expenditure item which exceeded this amount during fiscal year 1970-71 was for non-business state and local taxes.[3] Given such enormous costs each year, Congress should begin to wonder whether taxpayers really are getting their money's worth. Surprisingly, few have ever questioned the

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1 *See* U.S. TREAS. DEP'T, PRELIMINARY STATISTICS OF INCOME: 1970 INDIVIDUAL INCOME TAX RETURNS 40 (1972).

2 *Id.* at 28, 40. This calculation was based upon the information in Tables 3 and 7 of the report, assuming that the percentage of joint returns to total returns in Table 3 held true for itemized returns in Table 7 as well. Thus, combined rates ranging from 14% to 66% were applied to the charitable contributions for various brackets of adjusted gross income listed in Table 7. The result, of course, is a very rough estimate. To this estimate could be added the taxes relating to corporate contributions and, arguably, a portion of the standard deduction to arrive at a figure approaching the total federal income tax cost.

A broader estimate of $6 billion for 1967, reported in an article by Professor Lawrence Stone, included estate and gift tax deductions and income tax exemptions of charitable organizations. Stone, *Federal Tax Support of Charities and Other Exempt Organizations: The Need for a National Policy*, 20 U. SO. CAL. 1967 TAX INST. 27, 31 n.13 (1968).

3 117 CONG. REC. S18,764 (daily ed. Nov. 16, 1971).

charitable deduction.[4] On May 31, 1972, however, Representative Wilbur Mills and Senator Mike Mansfield introduced in Congress the Tax Policy Review bill,[5] which would, *inter alia,* repeal the charitable deduction unless Congress chose to re-enact it in similar or modified form. The bill, if enacted, hopefully would be treated as a long overdue call for a re-examination of the basic policy considerations upon which the charitable deduction is premised. This article will examine the policies underlying the federal income tax advantages for charitable contributions and will develop the thesis that the culprit is not the deduction but rather the exemption for charitable organizations.

Who should be the primary beneficiaries of any new approach to these provisions? The wealthy donor can generally take care of himself. The very size of his donation gives him some control over what is done with it. Small donors, however, who deducted gifts of over $6 billion in 1970, have no such power; they may at best select from an approved list of potential donees or decide not to give at all. One half of all individual taxpayers took no separate charitable deduction in 1970. These taxpayers were the involuntary donors of a large part of the $4 billion of lost government revenues.[6] Yet they possessed none of the powers of selection or control enjoyed by larger, voluntary

4 A few experts have commented generally on the need to subject the deduction to cost-benefit analysis. *See* Taussig, *Economic Aspects of the Personal Income Tax Treatment of Charitable Contributions,* 20 NAT'L TAX J. 1 (1967); 113 CONG. REC. 36,404 (1967) (remarks of Representative Mills). But most of the federal officials who were directly concerned with tax policy in 1968 seemed to be unconcerned. One commentator summarized the results of personal interviews conducted in 1968 with 35 members of the House Ways and Means and Senate Finance Committees and 13 officials in the Treasury Department, Internal Revenue Service, Department of Justice, and President's Council of Economic Advisers, as follows:

> In 1963 the Treasury Department put the "loss" of revenue entailed by the charitable deduction at about $2.8 billion. Yet none of the respondents seemed to be unduly concerned about this magnitude. One House leader said, "We can make it up by raising taxes."

T. HUNTER, THE TAX CLIMATE FOR PHILANTHROPY 68 (1968).

During the hearings which preceded the enactment of the 1969 tax reform legislation, Chairman Wilbur Mills of the House Ways and Means Committee structured an agenda that impliedly put such basic questions aside. *See Hearings on Tax Reform Before the House Comm. on Ways and Means,* 91st Cong., 1st Sess. pt. 1, at 5-6 (1969) (press release dated Jan. 29, 1969) [hereinafter cited as *Hearings*].

5 S. 3657 (H.R. 15230), 92d Cong., 2d Sess. (1972).

6 Technically, any donor who deducted amounts which saved him less in taxes than he would have received had the $4 billion been returned via a tax reduction was, to this extent, an involuntary donor. However, Congress would probably have instead used the $4 billion to increase its direct expenditures. Thus, each involuntary donor is entitled to protection extending to the entire $4 billion from which he would have received an individual benefit.

donors. The government which has required these involuntary donations has the duty to ensure that these taxpayers are getting their money's worth.

What is meant by "money's worth"? Most taxpayers probably think that the $4 billion somehow induced a significant increase in giving to charity. Studies indicate that this is not so.[7] Logic would seem to support this finding. True, a taxpayer might add to his donation an amount representing the government's share, but there is no reason to believe that he would increase his share just because the government stands ready to put in four dollars for each nine of his own. Some residual inducement value does seem to exist outside the area of strict mathematical logic. A taxpayer may feel that the burden of the whole gift is lessened by the deduction (and may thus increase his own share without actually figuring it out), or he may feel that the extra amount that the government is putting in makes the whole gift worthwhile. A small number of donors may even be motivated by the prospect of depriving the government of revenue.

Theoretically, a deduction might also serve as an inducement in the selection of one charity over another. A taxpayer might, in a close case, be induced to give to a government-approved charity rather than to a charity not favored by Congress in order to trigger the one-for-two government matching payment. Because a contribution to almost any charity is deductible if structured properly,[8] however, the idea that the government is trying to influence the selection of certain approved charities over others reduces itself to a matter of form and a trap for

7 Studies completed in the early 1960's concluded that the incentive value of the deduction is minimal. It has been estimated that in 1962 the $2.2 billion of lost individual income tax revenue induced only $57 million of extra individual giving. M. Taussig, The Charitable Contributions Deduction in the Federal Personal Income Tax 142 (1965) (unpublished doctoral dissertation, Massachusetts Institute of Technology). For a summary of this dissertation, see Taussig, *supra* note 4. Studies by two noted economists generally support this conclusion, especially for taxpayers in middle and lower tax brackets. *See* C. KAHN, PERSONAL DEDUCTIONS IN THE FEDERAL INCOME TAX 72 (1960); Vickrey, *One Economist's View of Philanthropy*, in PHILANTHROPY AND PUBLIC POLICY 31 (F. Dickinson ed. 1962).

8 The Internal Revenue Code permits a deduction for gifts to certain entities organized and operated exclusively for charitable purposes. INT. REV. CODE OF 1954, § 170(c)(2)(B) [hereinafter cited as CODE]. This deduction is permissible regardless of whether the entity has been approved for tax-exempt status under § 501(c)(3). The variety of purposes that qualify as "charitable" is virtually infinite. Deductions have been permitted for contributions to organizations ranging from the Birth Control League of Massachusetts (*see* Faulkner v. Commissioner, 112 F.2d 987 (1st Cir. 1940)), to a trust established to make awards to citizens rendering conspicuous service to the community. *See* Bok v. McCaughn, 42 F.2d 616 (3d Cir. 1930).

the unwary.[9] It is also true that contributions to certain preferred charities can be deducted up to a higher percentage of adjusted gross income,[10] but few donors ever approach the unpreferred twenty percent limit, let alone the fifty percent limit for gifts to preferred charities.[11]

For these reasons, the $4 billion in question is little inducement to net charitable giving. It is more accurate to think of the $4 billion as a grant-in-aid program. Or, because a major justification for the deduction has been thought to be a desirable transfer of decision making power from the government to private decision makers (the charities),[12] one could logically view the $4 billion as a revenue sharing program.

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9 For example, contributions to the American Birth Control League were held not deductible because of "propaganda" activities of the League (*see* Slee v. Commissioner, 42 F.2d 184 (2d Cir. 1930)), yet no one seriously questions the deductible status of contributions to the Roman Catholic Church on the basis of its recent lobbying efforts in New York against the retention of legalized abortion.

A related problem is presented by a donation to an organization which, although qualified at the time, abandons its charitable purpose. The donation then must be restored to income unless redonated to another qualified organization. *See* Rev. Rul. 566, 1954-2 CUM. BULL. 96. A deduction also will be denied if the donee has an organizational structure which is too informal. *See* Carolyn Trippe, 1950 P-H Tax Ct. Mem. ¶ 50,176 (1951).

10 CODE § 170(b)(1)(A). The annual limit for individual contributions to preferred organizations (churches, regular educational institutions, hospitals, domestic governments, certain organizations related to these organizations, and public foundations) was increased for the years after 1969 from 30% to 50% of adjusted gross income.

11 *See* U.S. TREAS. DEP'T, *supra* note 1, at 40. A high percentage of very wealthy donors, however, do utilize the full limit. *See* T. HUNTER, *supra* note 4, at 175-89. A survey based on personal interviews with 30 of the 47 persons who had announced contributions of at least $1 million in 1965 disclosed that over half (17 out of 30) had utilized the full limit (then 30%) in each of the previous 10 years. *Id.* at 177. It is possible, however, that this circumstance is due more to an uneven tax treatment of the difference between actual income and adjusted gross income (principally by reason of the exemption for interest on municipal bonds and the net long-term capital gains deduction) than to a propensity of the wealthy to give a higher percentage of their discretionary income to charity. The same survey reported that 18 of the 30 interviewees checked "tax considerations" as "very important" in deciding to make a gift. *Id.* at 179.

There also is a modest rise in the percentage of adjusted gross income donated by those with adjusted gross income over $100,000. One author feels, however, that "[t]he rise at the top is due to an increase in the ratio of contributions to income, reflecting the importance of philanthropy among the wealthy and the incentive for giftmaking provided by the tax deduction." J. PECHMAN, FEDERAL TAX POLICY 81 (rev. ed. 1971). Studies have not separated the incentive for making a full donation from that relating only to the amount of the net donation (the out-of-pocket amount after the tax savings).

12 *See, e.g.*, Rabin, *Charitable Trusts and Charitable Deductions*, 41 N.Y.U.L. REV. 912, 921-22 (1966): "The deduction may be viewed primarily as a device for decentralizing decisions concerning government expenditures."

Others prefer to focus upon the desirability of the activities of charitable organiza-

What have these private decision makers promised to do with this money or, if no meaningful promises have been made, what have they in fact done with past donations? In order to remain entitled to share in this revenue, an organization, as spelled out in the Internal Revenue Code,[13] must promise to operate solely for charitable purposes in a broad sense[14] and to refrain from any activities inconsistent with these charitable purposes.[15] These promises have not been construed as requiring the distribution or even the use of a single dollar of contributions received, including the annual $4 billion of government revenues, for charitable purposes.[16] All that is required is the distribution or use of any income obtained from investing the contributions received.[17]

In practice, tax-exempt foundations have tended to comply only with these minimal requirements.[18] Although some noteworthy exceptions could be listed, these organizations have shown that they really do not currently need more money. Over the years they have become so affluent that they can (or at least do) live on only the income

tions or upon the historic rationalization that the charitable deduction actually saves the government money; the deduction "permits individuals to divert tax funds to certain kinds of organizations. However, most people believe that the activities of these organizations are generally socially desirable." J. PECHMAN, *supra* note 11, at 82. Still others view the deduction as a revenue saving device. *See* D. SMITH, FEDERAL TAX REFORM 101 (1961): "[Private philanthropy] is a substitute for larger government expenditures in many areas, as in hospitals, and thereby reduces the general tax burden." The validity of this justification, however, turns on the existence of the deduction as an incentive for net giving, which, as noted earlier, is highly questionable.

13 CODE § 501(c)(3). The types of organizations exempt are corporations, community chests, funds, and foundations. There are, of course, many other organizations exempt under Code § 501(c). The discussion herein is limited to § 501(c)(3) and the corresponding portion of § 170(c), although much of the discussion would be equally applicable to other exempt organizations. The basic question in considering these other organizations would be whether they merely stand in the place of donors or are true charitable beneficiaries.

14 As used in this article, the term "charitable" includes all of the statutory purposes stated in Code § 501(c)(3), *i.e.*, "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals."

15 The requirement that the recipient be organized and operated "exclusively" for the statutory purposes has been construed to mean that an organization's exempt status can be revoked for substantial inconsistent conduct. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (1972).

16 *See* Rev. Rul. 149, 1967-1 CUM. BULL. 133.

17 This requirement is somewhat vague except in the case of private nonoperating foundations. Code § 4942 sets certain objective standards for income distributions required of private nonoperating foundations. *See* text accompanying note 103 *infra*.

18 This is not necessarily true of tax-exempt organizations other than foundations, although a substantial portion of contributions to educational institutions, for example, generally are permanently invested. *See Hearings* pt. 5, at 1814 (statement of Dr. E. Wilkinson, President, Brigham Young University).

from private and governmental donations.[19] More to the point, they have apparently decided that those presently in need of their charitable programs and grants are only needy enough (as compared to the needs of potential future beneficiaries) to require the income or the use of the income.

A taxable donor who retained and invested a similar principal sum, however, would receive no net tax benefit from annual gifts directly to needy beneficiaries of the income from such principal—even if such gifts were deductible—because the tax saved by the deductions would be offset by the tax payable on the income.

Why should Congress be so enamored of the institutional donors described in section 501(c)(3) that it is willing to pay $4 billion per year to help sustain their work when they promise little more and do nothing more than taxable donors who would receive no such benefits if they acted in like fashion? What should Congress demand in return for its $4 billion per year? And why should Congress not wait until that demand is met before giving up these huge sums?

I

UNDERLYING TAX POLICY

A charitable gift, in a nontax sense, is usually thought of as a transfer to or for the benefit of someone who is in need and who was selected primarily because of that need. Some donors feel that they are motivated by the charitable contributions deduction for donors and the tax exemption for donees provided in the Internal Revenue Code.[20] In carving out an exempt class of donees, however, Congress chose to focus not upon need but upon the organizational status of the class. An organization may achieve this status by promising that it will be organized and operated exclusively for charitable purposes, that is, for the benefit of those determined to be in need by such donee organization.[21]

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19 A sample 534 foundations were studied for the period 1951-1960 by the House Select Committee on Small Business, chaired by Representative Wright Patman. These foundations received $4.7 billion as income from investments but expended only $4.2 billion for grants and administrative and operating expenses. More than $2.3 billion received as new contributions during this same period was left untouched. HOUSE SELECT COMM. ON SMALL BUSINESS, TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON OUR ECONOMY, 87th Cong., 2d Sess. 4, 51 (Comm. Print 1962).

20 *See* note 11 *supra*.

21 The latest Internal Revenue Service listing of exempt organizations includes over 100,000 organizations which have made this promise and thus are qualified donees under

Congress, the Treasury Department, and the courts have created and refined a vast network of rules designed to hold these organizations to their promises.[22] The rules are in the form of prohibitions and requirements rather than inducements. Although partially successful in controlling tax-exempt organizations, the rules have created serious problems. Because they are generally objective in form and extremely complicated, they have in certain cases prohibited or unduly burdened otherwise desirable conduct.[23] The rules also undoubtedly have diluted the effectiveness of the deduction and exemption as inducements to the creation of charitable organizations, although it is hard to measure the extent of this dilution.[24]

The Internal Revenue Service has neither the equipment nor the incentive to police these organizations effectively.[25] Indeed, this policing function is foreign to the usual task of the Service which is to examine whether voluntary conduct by taxpayers has been reported correctly.

Even with adequate supervision the rules can perhaps never be sufficiently tough to close all avenues of escape. For example, Congress has shown only marginal concern for the organization which chooses to sit on its money and do nothing for true charitable beneficiaries. Churches, hospitals, universities, and public foundations can accumulate principal and income with impunity.[26] The only possible means

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§ 170(c). *See* U.S. TREAS. DEP'T, CUMULATIVE LIST OF ORGANIZATIONS DESCRIBED IN SECTION 170(c) OF THE INTERNAL REVENUE CODE OF 1954 (rev. ed. 1970).

22 Among the more important Code sections designed to regulate exempt organizations are § 503 (prohibited transactions), § 507 (termination of private foundation status), § 508 (special rules for § 501(c)(3) organizations), § 509 (definition of private foundation), §§ 511-14 (tax on unrelated business or debt financed income), §§ 4940-48 (excise taxes on self-dealing, income accumulations, excess business holdings, and improper investments and disbursements), § 1011(b) (basis in bargain sale to charity), and § 642(c) (deduction for amounts in estate or trust permanently set aside for charity).

23 *See* pp. 329-30 *infra*.

24 *See Hearings* pt. 1, at 81-82 (statement of M. Pattillo, Jr., President Emeritus, The Foundation Center). Dr. Pattillo urged simplification: "Almost no layman fully understands the present tax laws. I cringe at the thought that the laws may become even more intricate and abstruse." *Id.*

But Dr. Pattillo's plea was to no avail. Indeed, we are beginning to see the demise of some small charities as a direct result of the 1969 Tax Reform Act. *See, e.g.*, Estate of Harry L. Stern, 29 Am. Fed. Tax R.2d 72-503 (Pa. Orphans' Ct. Jan. 17, 1972) (charitable trust terminated because 1969 Tax Reform Act too burdensome).

25 *See* pp. 337-38 *infra*.

26 Prior to the 1969 Tax Reform Act, private foundations were prohibited from unreasonably accumulating income. *See* CODE § 504, *repealed*, Act of Dec. 30, 1969, Pub. L. No. 91-172, ch. 1, § 101(j)(15), 83 Stat. 527. No mention was made of principal. Section 4942 replaced this general prohibition with a requirement of current income distributions under a more objective formula; unfortunately, it applies to an even smaller group—private nonoperating foundations. Still no mention is made of principal.

of challenging the inactivity of these organizations is to argue that they have completely failed to live up to their promises and thus are not section 501(c)(3) organizations at all. The resulting sanction, complete taxation, is extremely difficult to enforce, primarily because of its severity.[27]

In practice this has meant that billions of dollars worth of contributions have never been put to charitable use or distributed to true charitable beneficiaries, and that billions more have only slowly trickled through section 501(c)(3) organizations to such beneficiaries.[28] The unused sums are presumably being held to aid future beneficiaries. No current law is violated by this practice. Nor does the practice seem to be morally troublesome to professional foundation managers.[29] Perhaps Congress ought benignly to defer to their judgment. Such inaction seems inappropriate, however, given the fact that billions of tax dollars have been poured into the pockets of charitable donors via the deduction and exemption without obtaining reasonably current benefits in return.

These matters are more fully explored in the following discussion, and two major changes in tax policy are suggested. First, the two tax benefits now available to a section 501(c)(3) organization—the receipt of a one-for-two government share and the exemption for investment income—should be made available only if and to the extent that the organization acts to pass through charitable benefits. Thus, if the organization delays the pass through, the related tax benefits also should be delayed. Second, these organizations, as well as all other taxpayers, should be induced, rather than required, to provide charitable benefits. Present attempts to enforce charitable promises should be abandoned; organizations should be free to delay or totally decline any tax benefits and to manage their properties as they see fit. The practical result of these changes would be to eliminate the need for classifying such charitable organizations separately for tax purposes. They would become fully taxable.

II

A Proposal for Reform

The following proposal would replace the present tax exemption with a charitable contributions credit available if and when property

27 *See* pp. 329-30 *infra*.

28 *See* p. 321 *infra*.

29 *See* pp. 323-28 *infra*.

is expended for charitable work.[30] Logically, a charitable contributions credit should not be provided for grants to intermediaries,[31] but only for direct expenditures, through grants or programs, to benefit true objects of charity. Because of the lack of an incentive effect on after-tax giving, if individual donors continued to give to intermediaries, the annual $13 billion could be expected to drop to about $9 billion of nondeductible contributions. Then, when expenditures were made by the intermediaries of this amount, the government could issue grants totaling $4 billion.

Because taxpayers have become psychologically accustomed to receiving a tax incentive for charitable contributions,[32] however, the proposal permits a charitable contributions credit for gifts to intermediaries matched by a tax of like amount for the same year that the intermediaries receive the gifts. This modification would eliminate an apparent bias against organized charitable intermediaries by permitting the government's share to pass through the donor's hands to the intermediary just as if the intermediary were itself a needy beneficiary to whom the donor had made a direct gift.[33]

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30 The use of a credit rather than a deduction is not new. In England a tax rebate to the exempt organization at a flat rate is available for donations made pursuant to a promise to give fixed sums for more than six years. This, in reality, is a credit, although payable directly to the exempt organization. *See* T. Hunter, *supra* note 4, at 67; Stone, *supra* note 2, at 30-31 n.11. Professor Stone notes that there might be a problem with a credit in the minds of some who feel that "the poor do not support the 'right causes,' such as higher education." *Id.* at 47 (footnote omitted). He indicates that a variable credit to remedy this feeling may not be politically feasible and that a deduction with a floor would be preferable. *Id.*

Others claim that the variable nature of the deduction which favors the rich is one of its chief problems. *See, e.g.*, White, *Proper Income Tax Treatment of Deductions for Personal Expense*, in 1 House Comm. on Ways and Means, Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base 371 (Comm. Print 1959). Still others feel that a direct grant would be even better than a credit. *See generally Hearings* pt. 1, at 5-6 (remarks of Representative W. Mills).

A credit, rather than a deduction, is suggested in the proposal for reasons of simplicity as well as the above considerations of equity. A deduction would require complicated rules to prevent income shifting from high to low brackets and, conversely, to prevent income bunching in large unincorporated foundations. What is new in the proposal, however, is the delaying of a tax benefit until the charitable organization expends a corresponding amount for charitable work.

31 By "intermediaries" is meant those organizations (or parts of organizations) which receive donations but do not themselves conduct charitable programs.

32 Even the sophisticated donor may think of the deduction as an inducement, and may be likely to differentiate, in this respect, between his gross gift and his gift net of taxes saved. *Cf.* T. Hunter, *supra* note 4, at 43-46.

33 Under the proposal, the present denial of tax benefits for individual charitable gifts directly to needy individuals would be removed.

The following specific changes would be incorporated into the Code to implement the proposed charitable contributions credit:

(*1*) Section 501(c)(3)[34] would be repealed.

(*2*) Section 170[35] would be reconstituted to permit a credit rather than a deduction, with the following additional changes:

(a) A "charitable contribution" would be defined as a gift or contribution of property—

(i) to true charitable beneficiaries;[36] or

(ii) in payment of the ordinary and necessary expenses or costs of assets directly related to a specific, currently operating charitable program;[37] or

(iii) to any person under circumstances reasonably indicating to the recipient that the property is intended for future disbursement as a charitable contribution.[38]

(b) Any taxpayer could take a charitable contributions credit equal to thirty percent of his charitable contributions for the year.

(c) Maximum annual charitable contributions credit:

(i) The present annual limits of twenty percent and fifty percent of adjusted gross income (for individuals) and five percent of taxable income (extended to cover all nonindividuals)[39] would be used to limit the amount of creditable contributions per year.

(ii) Contributions in excess of the limits in (i) would be creditable to the extent of current and accumulated contributions received under (a)(iii).

(*3*) A recipient of a charitable contribution described in (2)(a)(iii)

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34 *See generally* notes 13-15 and accompanying text *supra.*

35 *See* note 37 and accompanying text *infra.*

36 "True charitable beneficiaries" would be defined as persons unrelated to the donor, selected solely on the basis of need or such other factors as are normally used (as indicated by the nature of the gift).

37 "Charitable program" is used in the broad sense to cover all of the Code § 170(c)(2) purposes. These purposes are identical to the Code § 501(c)(3) purposes with the exclusion of testing for public safety. The focus, under the proposal, would be upon programs and not purposes—upon action rather than promises.

38 This might entail some simple record keeping by donors, perhaps by obtaining receipts which would indicate that the donee knew or should have known that the gift was charitable.

39 Estates and trusts would use the 5% limit. Thus, unincorporated foundations would be placed on a par with incorporated ones in this respect.

would be liable for a flat rate tax in the year of receipt equal to thirty percent of the amount of the contribution.[40]

A. *New Tax Policy*

This proposal would render foundations, churches, universities, hospitals, and all other section 501(c)(3) organizations fully taxable. In addition to taxing receipts of charitable contributions at thirty percent, the proposal would render dividends, interest income, capital gains, and other income of charitable organizations taxable in the same manner as those of other taxpayers. The charitable contributions credit would replace these lost benefits, permitting most charitable organizations to eliminate their tax liability through action rather than promises. The credit, moreover, would not just extend to these organizations but to all taxpayers. The same provisions would govern the initial donation and subsequent charitable uses or re-donations of the same property or its income. Intermediary organizations thus would be treated as donors rather than as section 501(c)(3) donees.

The charitable contributions credit would automatically render charitable contributions "current" in the sense that government revenues would not be depleted unless and until property were actually disbursed to needy persons or spent to pay for expenses or to purchase assets currently needed for charitable programs. No requirements for applying property in these ways would be retained in the Code. Thus, the government's share would serve only as an inducement. A taxpayer would know that for every nine dollars ultimately spent for charity, the government would spend four dollars.[41] In other words, the government would let the taxpayer spend the four dollars for charity. An identical inducement would exist for the spending of income from charitable contributions received.

Because of the annual percentage limitations, however, it would not be possible for a taxpayer to eliminate completely his tax liability each year merely by disbursing all of his income as charitable contributions unless he had a very small amount of adjusted gross income or a very great quantity of itemized deductions. Thus, for most taxpayers, tax free status could be preserved only for a limited time by making annual distributions of principal from charitable contributions re-

40 A 30% rate would produce revenue approximately equal to the revenue now lost, assuming that total charitable giving was not affected by the change.

41 In order to permit the taxpayer to spend the $4 even though he only has in his possession the after-tax amount of $9, the Code could allow the taxpayer to credit $13 for every $9 charitable contribution with the $4 refund paid directly to the donee designated by the taxpayer.

ceived.[42] Regardless of his economic status, however, a taxpayer could call upon the government to lend the same thirty percent support to his charitable choices. This alone would be a considerable improvement over the present system which permits taxpayers in the top individual tax brackets to contribute up to seventy percent of their donations to their favorite charities on behalf of the government while less wealthy donors may have to foot most of the bill themselves.[43]

On the other hand, if the proposal were to utilize a deduction rather than a credit, charitable receipts also would have to be taxed at the regular rates. This would penalize unfairly many larger foundations which presently operate as trusts. Moreover, to the extent that contributions to intermediaries are collected and concentrated, the overall amount of tax payable by them upon receipt might be greater than the corresponding overall tax saved by their donors. For these reasons, a flat rate credit seems preferable.

By substituting an incentive for the present multitude of requirements with which Congress now burdens exempt organizations (and especially private foundations), it would be permissible, as far as the Treasury were concerned, for such organizations to fail to live up to their selfless advertising. No tax revenues would be lost if this hap-

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42 For example, if an incorporated organization received a charitable gift of $1 million, it would pay a 30% flat rate tax in the year of receipt. If the remaining $700,000 were invested at 6% to earn $42,000 with annual expenses of $2,000, and the remaining $40,000 were distributed as charitable contributions, an additional $42,667 charitable contribution would be necessary to eliminate completely the tax otherwise payable. The credit would almost offset the regular tax:

Gross Income	$42,000
Expenses	2,000
Taxable Income	40,000
Gross Tax Payable	13,700
Less 30% Credit:	
Current Income Limit	(600)
Accumulated Donations Received	(13,100)
	-0-

Only $2,000 (5% of $40,000) could be treated as a contribution out of current income. This would produce a $600 credit (30% of $2,000). The remaining $13,100 would be 30% of an additional contribution of $42,667, and the remaining $30,400 would be applied to reduce accumulated contributions received. Thus, in about 25 years accumulated contributions would be used up and the organization, if no further contributions were received, would cease to exist. Its extinction, however, would be purely voluntary.

43 Charities selected by those who do not itemize their deductions, of course, receive no extra aid from the government. The new credit (CODE § 41) for 50% of political contributions of individuals up to $25 appears to be an attempt to recognize the inequity of deducting (rather than crediting) expenses such as this which are not related to personal or business expenses.

pened, and the burden of policing these organizations would be shifted to the donors whose individual contributions were not being used as intended. Perhaps state governments, which already share the policing burden, would take their responsibilities more seriously.[44]

B. *Additional Benefits*

Present law forces a donor to use an approved intermediary in order to obtain the benefit of a deduction. A small donor has no choice but to use already established foundations, funds, or other organizatious and then to sit back and hope that his money will be put to good use. Many such organizations are controlled by large donors or by boards comprised of the wealthy or the influential.[45] In order to receive a deduction, a small donor generally must turn his donation over to these people. By contrast, if a wealthy donor does not already control an existing foundation, it probably is feasible for him to establish one.

The proposal eliminates the need for approved intermediaries. A charitable contributions credit would be available for contributions directly to needy or worthy beneficiaries as well as to intermediaries. Even a small donor could establish a charitable program if he desired to do so. Expenses of such programs would be creditable, within limits, just as expenses of small businesses are deductible.

If an intermediary were used, it would not have to cut itself off from all noncharitable endeavors to remain in the government's good graces. A university could, for example, own and operate a macaroni factory. No harm would be done because both the university and the factory would be taxable, whether operated separately or as one entity.

An important change in the proposed definition of charitable contributions is the exclusion of endowments. No credit would be permitted for property placed in an endowment fund. A contribution to an endowment fund set up for charitable purposes would be creditable, but the fund, upon receipt of the property, would pay the thirty percent tax. Thereafter, the mere fact that the property was part of an endowment set up to finance specific charitable programs would not

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44 As one federal official stated, "The states should have responsibility for this kind of regulation. But they have done virtually nothing. Each of these organizations is a creature of a state." *Quoted in* T. Hunter, *supra* note 4, at 168.

45 *See* Harris, *Tax-Exempt Organizations*, in 3 House Comm. on Ways and Means, Tax Revision Compendium: Compendium of Papers on Broadening the Tax Base 2102 (Comm. Print 1959) (referring specifically to research institutes). The 1969 Tax Reform Act, which increased greatly the risk and expense of operating small private foundations, undoubtedly has served to increase this phenomenon.

permit the fund to take a charitable contributions credit. The charitable contributions credit would become available as income or principal of the fund was expended for program related assets or ordinary and necessary expenses. If at the end of the program remaining funds were distributed as a charitable contribution, a credit would be available.

Expenses for such programs could not be deducted alternatively as business expenses unless the requisite profit motive were present. The proposal thus would present no opportunity for tax manipulation other than that inherent in deciding whether any expenditure is or is not a business expense. The already familiar "ordinary and necessary" tests, which are used to circumscribe business expense deductions,[46] could be used to test the creditability of expenses related to charitable programs.

C. *Overall Effect*

The overall economic effect of the proposal, if an intermediary eventually does distribute all of the property received as charitable contributions, would merely be to deprive the intermediary of the present privilege of investing and earning a return on the tax dollars representing the government's share of the contribution. The proposal thus limits the government's share to thirty percent and no more. Under present law, the fact that the intermediary can receive and retain the whole contribution, including the government's share, creates an incentive to delay disbursements. The longer the delay, the greater the opportunity to invest and thus increase the government's share of the eventual distribution. This creates an unfair advantage over those organizations that may need to disburse funds earlier.

From the government's side, not only will the proposal limit the government's share to an even percentage but, to the extent that the present deduction causes a drain on revenues going to the benefit of intermediaries who never distribute the revenues as charitable contributions, the proposal will result in a permanent savings.[47]

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46 *See* CODE § 162.

47 As a side effect, the proposal would introduce more flexibility. Perhaps a wealthy donor did not really intend his family foundation (to which he is the sole donor) to be a charitable foundation. Or perhaps he later experiences a change in fortune and begins to wish that he had been less generous with past promises. Because the government has not yet disbursed any revenue to his foundation, there would be no reason for trying to lock in the donor's past contributions and then force them on through to true charitable beneficiaries.

III

Current Pass Through of Benefits

A. *Historical Perspective*

Although men may differ as to whether one beneficiary of charity is worthier than another, few have ever questioned the desirability of charitable giving. It is generally agreed that charitable organizations do good works and make good works by others possible. For centuries such institutions have been considered worthy of governmental support in the form of tax relief.[48]

In the United States, the first corporate income tax in 1894 contained an exemption for corporations and associations "organized and conducted solely for charitable, religious, or educational purposes."[49] No recorded legislative history states the reasons for this exemption. The Congressional Record reflects only some haggling over whether various other organizations should be similarly blessed.[50] One can only guess that the exemption was viewed as a proper helping hand to organized charity.[51]

It was not until 1917, when Congress raised the individual income tax rates to relatively high levels to help finance the First World War, that an amendment to provide for a charitable contributions deduction was introduced.[52] Then, as now, no one appeared to question whether the deduction cast doubt upon the continuing validity of what has come to be a related tax exemption.[53]

If a given organization were to promise to devote all of its own properties toward providing charitable benefits, it would not matter, from the standpoint of tax cost, whether principal were ever distributed. The tax cost would be spread out over the years since income would be earned tax free. Of course, in 1894 there could have been some legitimate interest in ensuring that tax free income was put to charitable use, but in those days it would have been difficult for an

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48 Tax exemptions for charitable organizations have been traced back to the sixth century B.C. T. Hunter, *supra* note 4, at 4.

49 Act of Aug. 27, 1894, ch. 348, § 32, 28 Stat. 556.

50 *See* 26 Cong. Rec. 6622-23, 6870, 6883-87 (1894) (remarks of Senators Hill, Perkins, and Teller).

51 The corporate tax rate in those days was only 2%, as was the federal individual income tax. Possibly some considered the status as reflecting a "hands off" policy similar to the First Amendment's separation of Church and State, or perhaps it was sufficient to recall that such exemptions dated from antiquity.

52 55 Cong. Rec. 6728 (1917) (remarks of Senator Hollis).

53 *Id. See also* note 4 *supra.*

organization to qualify as a tax-exempt organization at all if it did not have some kind of ongoing program that would automatically require at least some distribution or other charitable use of income.[54]

With the singling out of these same organizatious as qualified recipients of deductible gifts from others, the purely passive intermediary became a reality. The organization was no longer dealing with its own property but with a gift from someone else for which a deduction had already been taken. Only if it is assumed that Congress envisioned a recipient badly in need of funds for its ongoing charitable programs can Congress be forgiven its failure to realize that an exempt organization's duty might be different when dealing with someone else's deducted contribution than when dealing with its own property.

The Congressional Record reflects this concern. Senator Hollis, in urging the adoption of the deduction in 1917, emphasized that it was intended to counter the possibility that the new high wartime tax rates might cause a decline in charitable giving to educational institutions. Moreover, he argued that the deduction would save federal revenue because these charitable projects, if not funded privately, would have to be taken over in full by the government. To the extent that the deduction induced private funding, the government would be relieved of this expense.[55] Both of these arguments imply a reasonably current pass through of donations. Congress seemed to be focusing more upon encouraging the benefits that exempt organizations would confer upon needy persons than upon subsidizing the cost to the donor in making a charitable gift or upon making life easier for exempt organizations themselves.

B. *The Exempt Organization as an Intermediary*

Assume that an individual donor wants to make a contribution directly to some needy person or worthy cause. It makes little sense to say that he cannot deduct his contribution for such direct charity merely because the donee does not happen to be a favored exempt organization. If he can afford the time and expense he can set up a controlled charitable foundation as an intermediary and then take his deduction for a contribution to the intermediary. His tax-exempt foundation will then distribute his contribution, at his direction, to a needy person or worthy cause.

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54 Before the passage of the charitable deduction, there would have been fewer reasons for a transfer, for example, to a trust, which would result in a holding operation. Estate planning considerations would provide limited exceptions.

55 *See* 55 CONG. REC. 6728 (1917) (remarks of Senator Hollis).

The intermediary foundation itself need not undertake any charitable, religious, or educational activity to qualify for a tax exemption. Although probably aware of this circumstance in 1917, Congress undoubtedly did not consider the inactive intermediary to be the primary recipient of deductible donations.[56] Since 1940, however, there has been a tremendous increase in the number of tax-exempt organizations which do not themselves conduct charitable activities. A survey by the Treasury Department, using data for 1962, reported over 15,000 such foundations.[57] In a similar tabulation, the Russell Sage Foundation reported that, excluding some very small foundations, only twenty-six foundations which still exist predated the twentieth century, and only 591 were founded before 1940. In all, over 17,000 existed in 1966.[58]

No one knows exactly how many tax-exempt foundations are now in existence; however, the number is enormous and growing. There are numerous variations in the types of these foundations, but they share one common attribute: they are inactive intermediaries and, as such, they do not directly engage in charitable activities but rather receive, accumulate, manage, invest, and, hopefully, distribute charitable gifts to true charitable beneficiaries.[59]

It has long been recognized that there are some "bad apples" in the foundation barrel. Congress in 1950 and again in 1969 made extensive attempts to sort these out.[60] But what Congress apparently has failed to appreciate is that these intermediaries are not true charitable beneficiaries at all and should not be classified as such. These intermediaries really stand in the shoes of their donors. If any special tax treatment is necessary, logic impels that they be treated as donors, not as beneficiaries. As such, the only reason for rendering them tax-exempt is to avoid cancelling out the benefits of the charitable deduction to the original donors as donations pass through the intermediaries

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56 *Id.*

57 U.S. Treas. Dep't, Report on Private Foundations 77 (1965).

58 Russell Sage Foundation, The Foundation Directory 11 (3d ed. 1967). The study notes that of the "over $1 million" foundations (measured by the fair market value of current holdings), 47% were founded before 1940. *Id.* This figure must be augmented by those foundations (not included in the tabulation) which were organized for a special purpose, feeder organizations of other specific organizations, and publicly supported foundations.

59 This conduct is not unique to foundations. Churches, universities, hospitals, research centers, art museums, symphony orchestras, and the like also may serve in part as inactive intermediaries.

60 *See* note 22 *supra.*

to true charitable beneficiaries, assuming that the donations do in fact pass through.

C. *The Pass Through Problem*

The 1965 Treasury Department survey revealed that the over 15,000 foundations tabulated reported assets with a fair market value of about $15.5 billion. For the year, over $0.8 billion was received in new donations. The telling point is that these foundations' income (after expenses and including capital gains) was $1.1 billion, and their grants for the year totalled $1.0 billion.[61] Thus, no net disbursement of principal was made. Only current income from donations or from existing principal was passed through. Further, it is impossible to tell how much of this pass through actually was spent to benefit true charitable beneficiaries and how much simply went to other intermediaries.

This lack of disbursement of principal is not violative of our present tax laws. In 1950 Congress added to the Code section 504 which prohibited unreasonable accumulations of income. This section was replaced in 1970 by an excise tax (which rapidly becomes confiscatory) for failure to distribute income currently.[62] A minimum distribution requirement equal to six percent of asset fair market value is intended to ensure that the new excise tax will not be frustrated by investing in low income properties. The harshness of this new provision is mitigated by the continuation of the exclusion of long-term capital gains and tax-exempt interest from distributable income and by permitting the deduction of all ordinary and necessary expenses. The new rule, moreover, only applies to a limited type of intermediary—the private nonoperating foundation. Publicly supported intermediaries and intermediaries that also engage in substantial charitable activities are not covered. The Treasury Department figures indicate that even for those foundations covered the new excise tax will not change what foundations in general already do or, more accurately, do not do. It will affect only those stray foundations that are substantially below the average.

But why should the line be drawn at a distribution of income? Why not also require a distribution of principal? After all, by deducting a donation of principal and then sheltering the income in a foundation, the donor in effect is afforded a charitable deduction for both principal and all future income. For example, if a donor makes a $100 contribution to a foundation, he not only may deduct the $100, but he

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61 *See* REPORT ON PRIVATE FOUNDATIONS, *supra* note 57, at 79-80.

62 CODE § 4942.

also avoids reporting the income that the \$100 may earn while being invested by the foundation. This is equivalent to reporting the income earned by the foundation and then offsetting it with another charitable deduction.

If the same donor had not made a \$100 contribution but instead had invested the money at six percent, he would have had to report \$6 of income annually. If the \$6 had then been donated to the foundation each year, a \$6 charitable deduction could then offset his \$6 of income. If the foundation were to pass through the \$6, the annual benefit to true charitable beneficiaries would be the same as under the first alternative.

The only difference between these two alternatives is that by making a donation of principal the donor has irrevocably committed himself to donate the income each year to the foundation. Is this promise really important enough to justify a *present* deduction? Mathematically, the answer is yes. By making an irrevocable commitment, the donor has given away the present value of the sum of all future income and, at the end, any remaining portion of the principal. These together are equal to the present value of the principal. In the process, of course, he cannot retain the value of the property himself. But a charitable deduction is not primarily intended as compensation for what the donor gives up. His loss must be matched by a true charitable beneficiary's gain.

A similar argument of equality cannot be made regarding the benefits reaching true charitable beneficiaries. Just because the loss to the donor is the same whether he makes a present gift of principal or a present irrevocable commitment to give all future income, the intermediary cannot claim that the gain is the same to true charitable beneficiaries whether it makes a present distribution of principal or a present commitment to distribute the income as it comes in. To the donor, the income he may receive by investing his principal is a payment for giving up for a time the use of the principal and for the risk of collecting his income and, eventually, receiving back his principal. These factors bear little relationship to the real needs, both present and future, of charitable beneficiaries.

By making a contribution to an intermediary, the donor cannot say that it makes no difference whether the money is spent to satisfy present or future charitable needs just because it makes no difference to him whether he makes his contribution now or ties up property to ensure his making it later. In effect, the donor is saying to the foundation, "Give me your advice. If you think that present needs are more pressing, spend it now. If not, you can wait until later." The same amount of money (as measured by present value) will be available either way, but that does not mean that it will do the same amount of good whenever it is spent.

By leaving this choice up to the intermediary, Congress has also empowered it to make the same decision as to the taxpayers' share, the share equal to the taxes not collected. Should Congress trust intermediaries to make this choice? Should it not at least consider the matter? After all, a donor, at least of a sizable donation, can instruct the intermediary in this regard. In many cases, a large donor actually controls the intermediary. The government, as already mentioned, has become a large donor too. In 1970, of the over $4 billion related to individual donations alone, it is a reasonable estimate that almost $1 billion went to intermediaries.[63]

D. *Arguments for Accumulating Principal*

Many foundation managers and legislators argue that in order to provide a balance to the control which the federal government exercises over its vast revenues, nongovernmental decision makers should be allowed to decide when to spend for projects and also to decide which projects should be undertaken. This argument of managerial pluralism[64] is persuasive with regard to the nontax portion of charitable contributions. It would be persuasive as to the tax portion as well if that portion came only out of the pockets of the same charitable donors. The donors then would be choosing foundation managers over governmental managers.

To the extent that the government has to replace these lost tax dollars with funds from other sources, however, the choice becomes involuntary. This is especially true if the "other sources" are increased taxes collected from nondonors. Still, there is some persuasive force to the argument that our government has made a reasonable decision to let foundations share in the decision making process.

There is, however, little to commend the advance funding of foundations by the government upon the understanding that the foun-

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63 In 1962, about $1 billion out of a total of $4 billion in charitable contributions deducted went to foundations. *See* U.S. TREAS. DEP'T, STATISTICS OF INCOME: 1962 INDIVIDUAL INCOME TAX RETURNS 6-8 (1965). By 1970 the contributions deducted had risen more than threefold. *See* note 1 and accompanying text *supra*. If contributions to foundations also increased by the same multiple to over $3 billion, 30% of that figure would yield about $1 billion as the government's share.

64 *See, e.g.*, R. GOODE, THE INDIVIDUAL INCOME TAX 170-71 (1964); Fremont-Smith, *Duties and Powers of Charitable Fiduciaries: The Law of Trusts and the Correction of Abuses*, 13 U.C.L.A.L. REV. 1041 (1966).

dations may decide when to spend the money. This practice results in a hidden subsidy, *i.e.*, the extra income that foundations can receive by investing these tax dollars.[65] This amounts to an endowment of a promise—a very expensive way to achieve managerial pluralism.

Foundation managers also make the following arguments:[66]

1. *Benefits from Size*

A large foundation arguably can undertake many important though expensive projects which smaller foundations and individual philanthropists cannot. In most cases the price for this power and flexibility is the considerable delay which must be suffered while the foundation builds up to gigantic proportions through the accumulation of principal.

A smaller foundation, however, could also undertake large projects much sooner if it made its principal available rather than waiting until its income alone was large enough to handle the expense. The foundation might not continue in perpetuity, of course, if it spent principal.

2. *Expert Management*

Foundation managers point out that their "business" is charity and that they can put a wealthy donor's funds to much more productive use because of this expertise. Assuming that this is so, the fact remains that the funds must indeed be put to some charitable use to take advantage of these skills. If these skills are exercised only by way of prudent investment of principal and reinvestment of income, foundation managers are performing a service no different from that offered by most brokerage houses and large banks. Congress has not seen fit to place the latter institutions in the tax-exempt category, and foundations should fare no better.

3. *Difficulty in Spending Large Sums*

The argument that large sums are difficult to spend is persuasive only in the short run. Even a very large bequest could generally be put to good use over an extended period of time. Moreover, it is not necessary for the foundation to hold the taxpayers' share during the time necessary to make these decisions.

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65 *See* note 2 *supra*. If the estimated annual subsidy of $4 billion is invested at 6%, $240 million in additional subsidy is being paid each year. This $240 million is also tax-exempt, which makes the annual revenue loss even higher.

66 *See* 1 S. Weithorn, Tax Techniques for Foundations and Other Exempt Organizations § 11.02 (1964). *See generally Hearings* pt. 1, at 245-93, 354-431 (statements of J.G. Harrar, President of the Rockefeller Foundation, and McG. Bundy, President of the Ford Foundation).

4. *Insurance Against Hard Times*

Another short run argument is that foundations should be permitted to collect in good times and reserve some of that accumulated principal for expenditure in times of decreased giving. Foundations need not act as repositories for tax funds, however. Income from investing tax funds would make the accumulation of this reserve easier, but it is difficult to accord this need a high priority.

5. *Backing for Ongoing Projects*

A persuasive argument can be made for the proposition that a tax-exempt organization should be permitted to retain enough principal so that the income from that principal will be sufficient to cover the costs of some long-range fixed charitable commitment. For example, an organization might wish to endow a specific long-range medical research project, a hospital, a chaired professorship, a public gardens, or a Colonial Williamsburg. Some of these projects could not be undertaken if the organization had to rely on current donations or even on a short-term amortization of a principal sum for their maintenance. The nature of this type of undertaking requires economic security. Another reason for requiring an endowment would be to ensure a measure of independence from those persons who might wish to use proffered charitable donations to control the institution.[67]

The policy changes advocated herein would prefer current good works over the provision of either economic security or independence to long-range projects. The preference would operate most severely against programs of indefinite or unlimited duration. Not only would the income from the tax dollars be lost but, as a practical matter, the tax dollars would be lost as well. Only by overspending current income could these tax dollars be recovered, and this presumably would occur, if at all, only at the end of such a program.[68]

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67 Controversal programs at educational institutions may exemplify this reason. One well-known example was the funding by the Ford Foundation of the Ocean Hill-Brownsville project in 1968. This experiment in school decentralization caused serious disruption in the New York City schools involved. For this reason, the funding has come under sharp attack. *See Hearings* pt. 1, at 15 (statement of Representative W. Patman).

68 A good deal of economic security and independence could be achieved, however, by using the after-tax balance as an endowment. It is not clear why complete security and independence are desirable for any charitable project, especially if the project is beiug provided involuntarily by the general taxpaying public. The proposed changes would operate to require organizations to set some (perhaps long-term) life span on such projects or to engage in extra fund raising so that the entire program could be endowed with after-tax dollars.

6. *Present Tax Laws Encourage Donations*

If Congress were to take away the privilege of tax free accumulation of donations, some donors would decrease their giving because of the loss—perhaps permanent—of the funds now available from the government. This would be trne for those donors who never really intend for their gifts to be put to charitable use. For example, a donor might place a controlling block of stock in a family foundation in an attempt to perpetuate his control and to avoid having the stock scattered among his heirs or sold for taxes after his death. Clearly, Congress never intended to subsidize this effort with a tax deduction. Similarly, the "empire builder" who values the slow growth of a large foundation at the expense of present charitable work would be discouraged.

Many charitable donations have been made with the stipulation that the principal never be spent. This circumstance points out the most severe application of the proposed changes. Whether the funds were committed as specific backing or used as a general endowment, the tax dollars would be lost. In effect, no tax incentive would remain for such gifts. Although these gifts obviously are valuable to donees, they would no longer be subsidized.[69]

It is likely that many gifts in the same amounts would be made despite the absence of the deduction. The true donor should be encouraged in his giving by the knowledge that his principal will be put to early charitable use in order to obtain maximum tax benefits.[70] This conclusion appears even stronger with regard to lasting gifts such as endowments. The proposal, of course, advocates replacement not blanket repeal, and tends to focus the tax incentives where they are needed the most—on gifts to be distributed or used for the expenses of charitable projects.

E. *Argument for Current Distribution of Principal*

It has for so long been assumed that proper foundation management calls for a preservation of principal that it is difficult to find

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69 Subject to the annual percentage limitations, charitable spending of the income still would entitle the charity to a credit. In addition, it might be that state courts would be responsive to a request by foundation managers that such principal restrictions imposed in the past by donors now deceased be removed. Similar requests have been granted recently so that private foundations can comply with the 1969 Tax Reform Act requirements. *See In re* Estate of Barkey, 27 Am. Fed. Tax R.2d 71-804 (N.Y. Sur. Ct. 1971) (trustee ordered to act within 1969 Tax Reform Act rules, pursuant to doctrine of *cy pres*); Edward W. Bok Trust, 27 Am. Fed. Tax R.2d 71-1331 (Pa. C.P. 1971) (trust instrument amended to conform to 1969 Tax Reform Act rules, pursuant to general spirit of grantor's intent).

70 *See* note 7 *supra*.

people who will even question the propriety of the assumption.[71] This in itself is an argument for not leaving the decision solely in the hands of foundations. Foundation management should be required at least to consider the current distribution of principal.

In earlier times when such philosophical matters were discussed, a few heretics openly advocated this practice. For example, the late Julius Rosenwald, creator of the Julius Rosenwald Fund, is reported to have said:

> I am not in sympathy with this policy of perpetuating endowments and believe that more good can be accomplished by expending funds as Trustees find opportunities for constructive work than by storing up large sums of money for long periods of time. . . . Coming generations can be relied upon to provide for their own needs as they arise.[72]

Frederick T. Gates, a close adviser to John D. Rockefeller, Sr., is claimed to have told him:

> Your fortune is rolling up, rolling up like an avalanche! You must keep up with it! You must distribute it faster than it grows! If you do not, it will crush you and your children and your children's children.[73]

The elder Rockefeller apparently heeded this advice; the Rockefeller Foundation was not set up as a perpetuity (although, of course, it has been operated as such).

The fact that, on the average, no net distribution of principal is today being made by foundations should raise some eyebrows. Is it possible that current income from past donations is sufficient to take care of so many of our pressing charitable needs that those which remain are all outweighed by future charitable needs? In the public sector this is not thought to be the case. Imagine what would happen to the re-election chances of a politician who openly advocated taxing now to build up a reserve to be used to finance programs of future generations. Yet this is just what Congress is allowing to happen, albeit covertly, through the charitable deduction.

Even assuming that foundation managers are exercising their

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71 Even Representative Patman, after noting that "when a privilege is abused, it should be withdrawn," went on to explain that donations received would be excluded from the 20% tax that he would impose upon gross income of private foundations. *Hearings* pt. 1, at 12. As to required distributions, Representative Patman advocated only a requirement that they "spend, annually, their net income." *Id.* at 20.

72 *Quoted in* HOUSE SELECT COMM. ON SMALL BUSINESS, *supra* note 19, at 133.

73 *Quoted in* HOUSE SELECT COMM. ON SMALL BUSINESS, TAX-EXEMPT FOUNDATIONS AND CHARITABLE TRUSTS: THEIR IMPACT ON THE ECONOMY, 89th Cong., 2d Sess. 9 (Comm. Print 1966).

expertise, one might ask whether they labor under a conflict of interests. The foundation manager has a vested interest in the preservation of his own position or at least in the preservation of his foundation. If principal is spent, the foundation may run out of funds and cease to exist. But the taxpayer is entitled to have his interest represented in an unbiased manner. He is entitled to a decision made without prejudice as to whether the immortality of the foundation itself is impaired.[74]

The propriety of saving to meet future needs is highly questionable. If only current donations were spent along with income from past donations, the annual amount expended would be almost doubled. In other words, even after all accumulated principal were spent, a pass through of present donations would permit foundations and other intermediaries to maintain approximately their current level of distributions. It is as if we had set aside many billions as insurance against some unforeseen catastrophe. This display of affluence is hardly consistent with the picture painted by Senator Hollis of the struggle of our great educational institutions to avoid being run aground by the warship in 1917. Many of our schools are still struggling, and some have indeed run aground, while foundations continue to stockpile against the future.[75] Perhaps it is time for Congress to assume more control over its money.

IV

An Incentive Approach

Present statutory provisions exact too many needless promises in exchange for too great a tax break. In return for almost complete exemption from taxation, the Code demands that an organization promise that it will be "organized and operated exclusively" for certain named charitable purposes.[76] This means that the organization promises to refrain from fulfilling purposes other than those so named. The Code also prohibits causing any of the net earnings to inure "to the benefit of any private shareholder or individual."[77] Implied from these

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74 Perhaps more important than the possibility of bias in favor of perpetuity is the large degree to which our future charitable needs depend upon how successfully we cope with present needs. Today's areas of need were areas of need in the nineteenth century and will be such in the twenty-first century. Even those that seem new, such as problems of the environment, really are old problems just being recognized. Many of these problems would not exist today if we had solved their predecessors yesterday.

75 *See Hearings* pt. 5, at 1814-15.

76 Code § 501(c)(3).

77 *Id.*

promises is a more general promise to refrain from using the tax benefits in ways that would inure to the detriment of others.

The abuses, therefore, can be separated into two categories: undesirable benefits and undesirable detriments. If the organization confers a benefit made possible by its tax exemption upon persons who are not true charitable objects, this is an abuse whether or not others are directly hurt thereby. Such persons normally receive benefits because of their status as insiders, that is, as large donors, foundation managers, employees of foundations, suppliers, or others dealing with foundations.[78] Undesirable benefits may also be conferred upon employees, relatives, and friends of such persons.

Other abuses result in detriments to persons who would benefit if the organization's charitable activities were properly carried out. Such persons include true charitable beneficiaries who do not receive their rightful benefits, taxable competitors of the organization, or, in a more general sense, taxpayers whose money is being misspent.

The abuses in both categories can generally be associated with the performance of the three proper functions of an intermediary: the receipt of donations, the management of donated properties and of the income therefrom, and the charitable distribution of such properties and income.[79] Only the abuses which are made possible or made easier by the tax laws themselves, however, should be subject to control by those tax laws.[80] Thus, in exploring these abuses it is relevant to ask: (*1*) whether they are presently being handled in a satisfactory manner; (*2*) whether the conduct presently deemed abusive would continue to be deemed so if the proposal herein were adopted; (*3*) whether the proposal, without added restraints, would remove the advantages from such abusive conduct; and (*4*) whether the proposal would create new opportunities for abuse.

A. *The Statutory Dilemma*

Realizing that a complete job of curbing abuses is impossible under the current statute, Congress has attacked only the most serious abuses and, wherever possible, directed its attack toward only those

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78 *See generally* HOUSE SELECT COMM. ON SMALL BUSINESS, *supra* note 19.

79 It is beyond the scope of this article to attempt a survey of all such abuses. The purpose of this section is merely to demonstrate that the present requirements and prohibitions approach is inherently unworkable. For this purpose, the main focus will be upon the most recent legislative effort—the excise taxes enacted as part of the 1969 Tax Reform Act. *See* CODE §§ 4940-48, *added by* ch. 83 Stat. 498-518.

80 This statement is true only if one agrees with the conclusion that nontax abuses should be policed by states or by donors through lawsuits or decreased giving.

organizations that have been the most blatant violators.[81] Congress has shifted from primary reliance upon the courts to enforce broad statutory provisions, toward specific objective provisions that any court would be hard-pressed to ignore.

A dilemma has thus been created.[82] On the one hand it has long been clear that general statutes are simply not sufficient to force the courts to clamp down on foundations. Yet, because the more recent statutory provisions were drafted in objective form, the courts have been forced to steer a rigid middle course, permitting both unavoidable loopholes and areas of overkill.

Congress could further expand the number of statutory provisions to cover a greater number of variations, but the resultant regnlations would be unmanageable and would defeat the original objective of the charitable deduction. Some have charged that Congress has already expanded the provisions too far.[83] Most would concede that we are at least near the breaking point. The problems of underkill and overkill created by this dilemma must either be blindly tolerated or a new beginning must be sought.

1. *The Donation*

Probably the most obvious example of the statutory dilemma is the treatment of transactions between the charitable organization and certain related persons. Prior to 1950, the only sanction available against a charitable organization which transferred some of its exemption benefits to its creator, substantial contributors, or foundation managers was the total denial of exempt status.[84] The courts were reluctant to enforce this sanction. Violations were very difficult to uncover.

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81 *See, e.g.*, CODE §§ 4940-48.

82 *See Hearings* pt. 1, at 140 (statement of Professor L. Stone): "So you immediately start out with the dilemma of how do you control abuses without defeating your very purpose [of avoiding governmental control of project selection of direct governmental expenditures]." But Professor Stone then passes up a chance to re-examine basic policy: "I begin with the strong conclusion that the continued healthy existence of most of our exempt organization area is a vital matter to our free pluralistic society." *Id.* He concentrates instead on suggestions for more statutory "fine tuning":

> [I]n view of the large amounts of money involved in the tax benefits granted to these organizations and their donors and in view of the extremely current pressing needs for Government revenues, it seems to me that many benefits that were granted decades ago to certain nonprofit organizations must be revised and in some cases removed.

Id. at 141.

83 *See Hearings* pt. 1, 81-82 (statement of M. Pattillo, Jr., President Emeritus, The Foundation Center).

84 *See* CODE § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1 (1959).

In 1950, Congress added to the Code section 503 which provided that a section 501(c)(3) organization would lose its tax-exempt status for at least one year for engaging in any of the specified non-arm's-length "prohibited transactions" with certain insiders. This section proved difficult to enforce, however, partly because of the severity of the sanction and partly because the specified transactions were insufficiently concrete to catch other than the most obvious abuses.[85] The sanction, moreover, applied only to privately supported organizations other than churches, schools, and hospitals.

Beginning in 1970, this section was replaced (as it related to section 501(c)(3) organizations) with section 4941,[86] which has expanded the types of prohibited transactions to include many which are clearly arm's-length. The section now applies only to nonoperating private foundations.

In judging section 4941, one should remember that the opportunity for self-dealing probably is present both in the management function of any organization and in nearly any donation of property of high value. Thus the statute clearly does not go far enough toward eliminating this area of abuse.

On the other hand, as measured by the above definition of abuse,[87] the section operates too severely upon private foundations. Arm's-length sales, exchanges, leases, or uses of the charity's property are prohibited if the foundation is dealing with a substantial contributor or foundation manager (or with some other "disqualified person").[88] Also prohibited are sales at arm's-length or at bargain prices by disqualified persons to their foundations, and the leasing of properties by such persons to foundations without charge.[89] These provisions were thought necessary primarily because it had become too difficult to distinguish between arm's-length and non-arm's-length transactions.[90] The prohibition of donations made by disqualified persons, if the foundation assumes a mortgage or even takes subject to a recent mortgage, clearly cuts down on desirable flexibility in charitable giving.[91] Prohibition of loans to private foundations from disqualified persons also eliminates a method of advancing charitable donations to

85 *See generally Hearings Before the Senate Fin. Comm. on the Tax Reform Act of 1969 (Statements and Recommendations of the Dep't of the Treas.),* 91st Cong., 1st Sess. pt. 1 (1969).

86 *See* CODE § 4941(d).

87 See p. 329 *supra.*

88 CODE § 4941(d). For the definition of "disqualified person," see *id.* § 4946(a).

89 *Id.* §§ 4941(d)(1)(A), (2)(C).

90 *See Senate Fin. Comm. Hearings, supra* note 85, pt. 1, at 12.

91 CODE § 4941(d)(2)(A).

earlier dates.[92] Even interest free loans are prohibited unless the proceeds are used for section 501(c)(3) purposes.[93] This last requirement seems to have been ignored in the proposed regulations interpreting section 4941.[94] Does "used" mean that the principal must be disbursed or merely invested? If it must be disbursed, then how soon? Again, the furnishing of goods, services, or facilities to the organization is prohibited. This provision would seem to prohibit most donations in kind. The furnishing of such items without charge, moreover, is permitted only if the items are, as with loans, used solely for section 501(c)(3) purposes.[95]

This provision also would prohibit disqualified persons from furnishing (except without charge) necessary management services such as investment and legal advice were it not for a subsection which permits the private foundation to pay compensation for services reasonable and necessary for the discharge of its exempt purpose if the amount is not excessive.[96] Although these two paragraphs of the proposed regulations seem contradictory, read together they at least prohibit paying for services in connection with unrelated business income. In fact, a disqualified person could not render such services even for free.[97]

Finally, section 4941 prohibits any transaction or use of income or assets which directly or indirectly benefits a disqualified person. At best this catchall is a trap for the unwary; at worst it brings back all of the pre-1969 Tax Reform Act problems. Several examples in the proposed regulations show how confusing this area has been. The proposed regulations differentiate between "incidental or tenuous" benefits which are acceptable and other more substantial benefits which are not.[98] Section 4941(e)(3) talks of correction of these abuses by the application of "the highest fiduciary standards." If this is interpreted as a definition of what constitutes an abuse in the first instance, then the statute will

[92] If a donor wished to make a contribution in a year when his adjusted gross income was inadequate to permit a full deduction, it was common to loan the property to the foundation and then to forgive the loan over a period of several years. The five year carryover for excess gifts to preferred charities is of some help with this problem. *See id.* § 170(d). This and other drawbacks apparently were thought by the Treasury Department to be unavoidable. *See Senate Fin. Comm. Hearings, supra* note 85, pt. 1, at 12-13. A reading of the arguments for and against the various proposals demonstrates the statutory dilemma created by Congress.

[93] CODE § 4941(d)(2)(B).

[94] *See* Proposed Treas. Reg. § 53.4941(d)-2(c)(2), 36 Fed. Reg. 10,971 (1971).

[95] CODE § 4941(d)(2)(C).

[96] *Id.* § 4941(d)(2)(E).

[97] *Id.* §§ 4941(d)(1), (2)(C).

[98] Proposed Treas. Reg. § 53.4941(d)-2(f), 36 Fed. Reg. 10,972 (1971).

have come full circle and will have returned to the most ancient of common law criteria governing insider conduct, "fiduciary duty."

The main point, however, is that these problems cannot be corrected without the addition of even more detailed and specific statutory language; yet, the more detailed and specific that this language becomes, either through litigation or legislation, the more detrimental the overall effect.

None of this would be necessary under the proposal advocated herein. If an organization is not tax-exempt, abuse of a tax exemption would, of course, be impossible. For example, the passing through of tax exemption advantages to disqualified persons by direct sales, loans, or leases at rates which are at arm's-length to the private foundation but are more favorable to disqualified persons are now prohibited because of competition with taxable persons. Nontax benefits such as the use of foundation property as security for loans to disqualified persons and the holding or voting of property for the benefit of disqualified persons as well as more blatant forms of abuse still would occur. These activities would still constitute abuses, but under the proposal the taxpayers' dollars would not be involved. As a result, those still interested, such as donors or state governments, would themselves have to carry the enforcement burden.

2. *The Management Function*

In 1954, Congress imposed taxes at regular rates on unrelated business income,[99] and, in 1969, an excise tax relating to excess business holdings was enacted.[100] Congress was worried about two things: the use of the tax exemption to compete unfairly with taxable competition, and the use of foundations to control businesses and thus to shelter large amounts of taxable income. It is not clear, however, whether business activities by foundations are considered improper per se. Some have suggested that substantial involvement in noncharitable activities would take up too much of a foundation manager's time and divert his attention from charitable goals.[101] A similar argument could be made, however, with regard to the management of a "passive" investment portfolio.

The related-unrelated dichotomy as a method of defining what income shall be subjected to regular taxation is unfair to those who compete with tax-exempt related businesses. This dichotomy, more-

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99 CODE §§ 511-14.

100 *Id.* § 4943.

101 *Senate Fin. Comm. Hearings, supra* note 85, pt. 1, at 15-16.

over, has proved difficult to administer.[102] The proposal would continue to aid in the procurement of capital for related businesses but would end the tax exemption for income earned by such businesses. A charitable contributions credit could be taken by such businesses, of course, to the same extent available to other taxable competitors.

Sections 511-14 and, to a greater degree, section 4943 are also directed at preventing excessive sheltering of taxable income. This stems from a fear that the economic and political power of foundations might grow to gigantic proportions with the aid of the exemption and, consequently, that federal revenues might be depleted.[103] The proposal would eliminate some of the present aid to inordinate growth. The charitable contributions credit would be available, however, when properties were used to purchase related capital assets. This would aid growth, but only that growth related to charitable programs and not growth merely resulting in larger foundations per se. The intermediary would not be aided by the tax statutes since the charitable contributions credit would be available only for operating or disbursing activities. This is as it should be. Far from fearing growth in these areas, the sponsors of the deduction originally intended it to facilitate such growth.[104]

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102 Examples of such related businesses include educational testing services, hospital diagnostic services, research and testing businesses, university presses, and proprietary educational institutions.

Code § 513 throws the ball to the Treasury and to the courts by defining "unrelated trade or business" as "any trade or business the conduct of which is not substantially related" to its exempt purpose. In C.F. Mueller Co., 55 T.C. 275 (1970), the Tax Court denied a charitable deduction claimed by a company for contributions to an exempt trust for the benefit of New York University Law School. The company was deemed to be owned beneficially by the University.

The Ford Foundation in 1966 and 1967 reportedly lost $92,500 and $100,000 respectively by charging low prices in a cafeteria and dining room in its New York City office building. Taxable competition thus lost over 300 regular customers. The Rockefeller Foundation, according to the report, incurred losses of about one half of these amounts in a similar operation. *Hearings* pt. 1, at 15 (remarks of Representative W. Patman).

103 *See generally Hearings* pt. 14, at 5326-31 (general explanation by Treas. Dep't).

104 With regard to the sheltering of income, Code § 514, the Clay Brown provision, deserves some mention. The abuse here, first condoned by the Supreme Court (*see* Commissioner v. Brown, 380 U.S. 563 (1965)) and then condemned by Code § 514 (introduced in the 1969 Tax Reform Act), involved the purchase of corporate stock at a more favorable price than the seller would be able to obtaiu from a taxable buyer. This was accompanied by a liquidation following the stock purchases and a lease back of the assets to a new corporation owned by the old stockholders. The original stock was purchased wholly on credit and the payments on this debt consisted of a return of most of the rents received under the lease.

Because this resulted in a shift of some of the tax exemption advantages to taxable persons and made it far too easy to purchase on credit and then shelter the resulting income, this practice was outlawed. That portion of the rental income which bears the

3. *The Distribution Function*

Code section 4944 prohibits a private foundation from investing "any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes."[105] The legislative history of this section shows that congressional intent was to discourage speculative investments.[106] The section could also be applied, however, to discourage all long-term investments. The section is directed to the failure to exercise ordinary business care and prudence with regard to the long- and short-term financial needs of the foundation to carry out its exempt purposes.[107] These needs may include "the expected return, the risks of rising and falling price levels, and the need for diversification."[108]

This brief summary demonstrates the dilemma created by Congress in enacting the present statute. Section 4944 may prove inadequate because of its application only to private foundations and because of the relatively low penalty taxes of from five percent to twenty-five percent, the exclusion of certain investments, and the failure to provide for a continuing review of the portfolio. In other respects the section may be too harsh, causing foundation managers to shy away from some arguably sound investments because of the risk of being second-guessed. As a practical matter, these abuses can never be totally eliminated. Moreover, the examples of prohibited investments do not allow flexibility depending upon whether the investments are or are not related to the charitable programs of the foundation involved.

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same ratio to the rental income as does the debt to the basis of the property is deemed "unrelated business income" and taxed. CODE § 514. In a market dominated by taxable persons, the purchase potential of exempt organizatious would be unlimited. Although § 514 did close this loophole, the proposal herein would place charitable organizations on even ground with other taxpayers and thus would eliminate the opportunity for this abuse without having to restrict other, perhaps desirable, credit purchases as is presently the case.

105 CODE § 4944(a)(1).

106 *See* S. REP. No. 552, 91st Cong., 1st Sess. 45 (1969).

107 *Id.* at 45-46.

108 Proposed Treas. Reg. § 53.4944-1(a)(2)(i), 36 Fed. Reg. 12,026 (1971).

The proposed regulations would not, however, place upon foundation managers a continuing duty to review investments once made and determined as of that time to be proper. *Id.* Two examples in the proposed regulations would prohibit substantial investments in common stock of (*1*) a corporation with no dividend record, some profit years and some substantial loss years, and serious under-capitalization—even with a promising product, and (*2*) a corporation with a heavy reliance on a new product that must compete with products in a well-established alternative market and the stock of which is classified as a higb risk investment. *Id.* § 53.4944-1(c), 36 Fed. Reg. 12,026 (1971). Program investments are excluded by § 4944(c), and investments received by donations or in tax free reorganizations are excluded by the regulations. *Id.* § 53.4944-1(a)(2)(ii), 36 Fed. Reg. 12,026 (1971). Apparently the statutory basis for this Proposed Regulation is that there has been no amount "invested" as required by Code § 4944(a)(1).

Finally, the prohibitions apply equally to the investment of the private share of donations and of the government's share.

This extra protection cannot be justified by the government's interest in protecting the tax laws from abuse. The proposed credit would not automatically eliminate the possibility of speculative or long-term investments which jeopardize charitable spending or programs by reducing current income or liquidity. It would, however, eliminate the government's interest in seeing that its own revenues are not subjected to such abuses, since government revenues would not be made available for *any* investments, speculative or not.

Protection for the private portion of donations would be left to donors or state governments. For organizations other than private foundations, the Code sanction against investments that jeopardize the charitable function is effective only when the jeopardy becomes so blatant that the organization ceases to be organized and operated for charitable purposes. This virtually unworkable standard, which is presently applicable to public charitable organizations, also would become unnecessary if the proposal herein were adopted.

Section 4942, a further requirement applicable only to private nonoperating foundations, requires the distribution of at least six percent of asset fair market value, or all income, within twelve months of the year in which the income was earned. This section replaces former section 504, which in general terms prohibited "unreasonable accumulations" of income.[109] The sanction for violation of section 504 (loss of exempt status for a minimum of one year) had proved unworkable.

Under the proposal, however, the government would have no revenue at stake in desiring an early distribution of either income or principal. Although the proposal would not serve as a strong incentive for early distribution, the present disincentive would be removed.

Finally, an abuse may consist of distributions made to noncharitable beneficiaries in derogation of the original intent of donors. Rather than attempting to strip organizations of tax-exempt status or to place a penalty tax upon them, such as that presently applicable to private foundations under section 4945,[110] the proposal would shift the focus to a determination of what *does* qualify as a creditable contribution. It would reflect what has become clear over the years—that it is

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109 *See* p. 321 *supra.*

110 Section 4945 prohibits expenditures by private foundations for certain political purposes, for travel or study grants to individuals (unless made via a procedure approved in advance), to other private foundations (unless supervised by the donor organization), and "for any other purpose other than one specified in section 170(c)(2)(B)."

particularly difficult to force anyone to be charitable if he does not desire to be so, regardless of whether or not he has in the past made promises to that effect.

It is probable, of course, that even if the proposal were adopted some charitable organizations would still engage in noncharitable conduct and thus would continue to frustrate the intent of small donors. It is also possible to try to stop these abuses through the Code. Experience has shown, however, that the federal government is not well-suited to this task. By assuming this duty, moreover, the federal government has led others (states and private persons) toward complacency, a complacency which has proven to be unjustified since the federal duty has not always been adequately discharged.

B. *Enforcement Problems*

In addition to examining the statutory provisions designed to control abuses, one must examine how these provisions have been implemented in practice. The Internal Revenue Service, which has the sole responsibility for enforcement, is hampered in two ways.[111] First, it is asked to function as a policeman, a role foreign to its usual task of seeing whether voluntary conduct has been properly reported. The Service usually is concerned with whether the taxpayer did what he says he did, and, if so, whether the proper tax has been paid. The exempt organization provisions require the Service to inquire further to see if the taxpayer did what he should have done. This requires an immense amount of information about each organization. Until recently, the Service received very sparse information through Form 990-A. A revised form now requires more information, but it in no way approaches what would be needed to do a complete job. Effective regulation, moreover, requires that organizations fill out the form properly. Unfortunately, in many cases they do not.[112] If the abuse in question is in violation of the Code and is intentional, it may safely be assumed that the organization will try to conceal this on the form.

Second, the enforcement incentive to the Service is in some cases too little and in others too great. Prior to 1969, section 504 carried the loss of exempt status as the sanction for excess income accumulation.

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111 Some harsh words have been written in recent years concerning the general lack of effectiveness of Internal Revenue Service enforcement of the Code provisions in the exempt organization area. Prior to the 1969 Tax Reform Act, the response was that the lack of revenue potential to the government was the cause. It remains to be seen whether adequate incentive now exists in the private foundation area. *See, e.g.*, HOUSE SELECT COMM. ON SMALL BUSINESS, *supra* note 19, at 27-28; *Hearings* pt. 1, at 145, 150-51, 191.

112 *See Hearings* pt. 1, at 145.

The Service found that the courts were reluctant to apply this severe sanction. The result in most cases was no sanction at all, leading to a lack of interest in Service enforcement. The 1969 Act incorporates a new approach consisting of graduated penalties for conduct specifically defined. Although this may be of some help, the fact remains that these sanctions, as excise taxes, are really penal in nature. It is difficult to prosecute for unintentional violations even if intent is immaterial under the statute. Moreover, these excises rapidly become confiscatory and thus may prove even more severe than the loss of exempt status for a year.

Probably the most serious enforcement problem, however, is the immense amount of noncompliance, not necessarily to cover up abuses, but from what has been termed the "snicker" effect.[113] Many foundations realize that the Internal Revenue Service has neither the equipment nor the financial incentive to police their conduct. Therefore, they have been inclined to ignore, or to treat as so much governmental red tape, such provisions as the technical reporting requirements, the requirement of adherence to exclusive charitable purpose, and the prohibitions against political involvement. Even some larger, better known foundations have been accused of these types of violations.[114] This circumstance indicates that a basic premise of our tax philosophy—that voluntary compliance will be achieved through a belief in the statute's general fairness—is invalid in this area.

CONCLUSION

Clearly, the present approach to charitable exemptions and deductions is not working. To date, however, Congress has had no choice but to stay with it or to abandon the conferment of tax benefits altogether since it has been reluctant to meddle with the basic benefit of an exemption for a promise.

A purist might argue that the government ought to go all the way and eliminate all Code incentives for charitable giving and replace them with a grant program.[115] Even then, however, the grant should be paid not for a promise but for action. This is substantially what the proposed charitable contributions credit would do, but with several

113 *See* T. HUNTER, *supra* note 4, at 30.

114 *See* HOUSE SELECT COMM. ON SMALL BUSINESS, *supra* note 19, at 12.

115 The Assistant Secretary of the Treasury for Tax Policy, Edwin S. Cohen, is reported to have urged the total elimination of the charitable contributions deduction on the ground that it is "unrelated to the receipt of income." Wall St. J., June 2, 1972, at 4, col. 3.

important differences: by placing the incentive in the Code and making it automatic, not only will bureaucratic decision making be reduced and certainty increased to the donor and intermediary, but the desirable separation or plurality of management would be preserved.[116]

If it was not clear before, it should be clear from our experience since the 1969 Tax Reform Act that the present "requirements" approach to enforcing good behavior by foundations will not be successful. An incentive approach is suggested as an alternative. But a most important point is that the two suggested policy changes are tied together. Whatever desirability the incentive approach may have, it is impossible to implement unless it is accompanied by a limitation of tax benefits to current charitable spending. That is, if the incentive is not triggered by an actual expenditure rather than a promise, there will remain the problem of how to police the organization between the time the tax benefit is granted and the time the charitable expenditure takes place.

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116 *See generally* Surrey, *supra* note 3. Professor Surrey does include the charitable contributions deduction in his list of incentives that ought to be removed, but his analysis indicates that the deduction is vulnerable on grounds that an incentive may not be needed and that the rich benefit from it more than the poor. If these defects were corrected, subsidies through automatic provisions in the Code would seem to be more desirable than direct grants as the means to achieve managerial pluralism.