PRIVATE FOUNDATION LEASING OF BUSINESS ASSETS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

FIRST SESSION

ON

S. 1514

A BILL TO AMEND SECTION 4941 OF THE INTERNAL REVENUE CODE OF 1954, AND SECTION 101(1)(2) OF THE TAX REFORM ACT OF 1969

JULY 25, 1977

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PRIVATE FOUNDATION LEASING OF BUSINESS ASSETS

MONDAY, JULY 25, 1977

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
GENERALLY OF THE COMMITTEE ON FINANCE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m. in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee), presiding.

Present: Senator Byrd.

Senator BYRD. The hour of 2 o'clock having arrived, the committee will come to order. The hearings this afternoon deal with S. 1514, a bill sponsored by Senator James B. Allen of Alabama, and cosponsored by Senators Sparkman of Alabama and Thurmond of South Carolina.

[The committee press release announcing this hearing and the bill S. 1514 follow:]

[Press Release from Committee on Finance, U.S. Senate, July 15, 1977]

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT ANNOUNCES HEARING ON S. 1514

Subcommittee Chairman Harry F. Byrd, Jr. (I., Va.) today announced that a hearing will be held on July 25, 1977, on S. 1514. The bill would amend Section 4941 of the Internal Revenue Code of 1954 and Section 101 (1) of (2) of the Tax Reform Act of 1969.

The sponsor of the legislation is Senator James B. Allen, and the bill is cosponsored by Senators John Sparkman and Strom Thurmond.

The hearings will begin at 2:00 P.M. in Room 2221 Dirksen Senate Office Building.

In announcing the hearings, Senator Byrd stated that the intended beneficiaries of the bill are: Public Welfare Foundation, Inc., a non-profit private foundation organized by Charles E. Marsh which is exempt from Federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1954; the taxable, wholly-owned subsidiaries of Public Welfare Foundation, Inc. (The Spartanburg Herald and Journal, Inc., The Gadsden Times, Inc., and The Tuscaloosa News, Inc.); and three newspaper operators (Newspaper Management-Production, Inc., Gadsden Times Publishing Corporation and Tuscaloosa Newspapers, Inc.) who lease the assets owned by Public Welfare Foundation, Inc.'s wholly-owned subsidiaries.

The principal owners of the three operating companies are, respectively, Phil Buchheit, Frank Halderman, Sr., and James B. Boone, Jr. The newspapers operate in South Carolina and Alabama. No revenue loss or gain is anticipated from the measure.

Witnesses who desire to testify in the hearings should submit a written request to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510 by no later than the close of business on July 21, 1977. Treasury comments on the proposed legislation are requested.

LEGISLATIVE REORGANIZATION ACT

Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify must comply with the following rules:

(1) A copy of the statement must be filed by the close of business two days before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 75 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for oral presentation.

WRITTEN TESTIMONY

Senator Byrd stated that the Subcommittee would be pleased to receive written testimony from those persons or organizations who wish to submit statements for the record. Statements submitted for inclusion in the record should be typewritten, not more than 25 double-spaced pages in length and mailed with five (5) copies by August 22, 1977, to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D.C. 20510.

[S. 1514, 95th Cong., 1st sess.]

A BILL To amend section 4941 of the Internal Revenue Code of 1954, and section 101(1)(2) of the Tax Reform Act of 1969

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

(a) Section 4941(d)(2) of the Internal Revenue Code of 1954 is amended as follows:

(1) by striking out "and" at the end of subparagraph (F);

(2) by striking out the period at the end of subparagraph (G) and inserting in lieu thereof "; and " and

(3) by adding at the end of such paragraph the following new subparagraph:

"(H) The leasing of property by a corporation, all the stock of which is owned by a private foundation, to a disqualified person shall not be an act of self-dealing if (i) it is pursuant to a binding contract in effect on October 9, 1969 (or pursuant to renewals of such contract); (ii) the leasing at no time constituted a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law); (iii) the terms of the lease are no more favorable to the disqualified person than those under which the corporation would lease the property to an unrelated party in an arm's-length transaction; (iv) the lessor corporation is not exempt from tax under subchapter F; and (v) the disqualified person became such solely because of contributions made to the private foundation prior to October 9, 1969."

(b) Section 101(1)(2)(B) of the Tax Reform Act of 1969, as amended by section 1309 of the Tax Reform Act of 1976, is amended by striking out "January 1, 1977" and inserting in lieu thereof "January 1, 1990".

(c) Section 101(1)(2)(C) of the Tax Reform Act of 1969 is amended by striking out "December 31, 1979" and inserting in lieu thereof "December 31, 1989".

(d) Section 101(1)(2)(F) of the Tax Reform Act of 1969, as added by section 1301 of the Tax Reform Act of 1976, is amended by striking "January 1, 1978" from subparagraph (ii) and inserting in lieu thereof "January 1, 1990".

Senator BYRD. The bill would amend section 4941 of the Internal Revenue Code of 1954 and section 101(1)(2) of the Tax Reform Act of 1969. These parts of the tax law deal with sales, exchanges or leases between private foundations and disqualified persons. The intended beneficiaries of this legislation are the Public Welfare Foundation,

incorporated, its wholly owned subsidiary, and the newspaper operators in the cities of Spartanburg, S.C. and Gadsden and Tuscaloosa, Ala.

Senator Allen, we are pleased to have you and you may proceed in any way that you wish, Senator.

STATEMENT OF HON. JAMES B. ALLEN, A U.S. SENATOR FROM THE STATE OF ALABAMA

Senator ALLEN. Thank you very much, Mr. Chairman.

We are delighted to have this opportunity to appear before your subcommittee and we appreciate your giving us this special sitting of the subcommittee.

On May 13, 1977, Senator John Sparkman and Senator Strom Thurmond joined me in introducing S. 1514 to amend Section 4941 of the Internal Revenue Code of 1954 and section 101(1)(2) of The Tax Reform Act of 1969.

On May 9, 1977, Congressman Tom Bevill of Alabama on behalf of himself and Congressman James R. Mann of South Carolina, Congressman Kenneth Holland of South Carolina and Congressman Walter Flowers of Alabama, introduced H.R. 7003 in the House of Representatives. H.R. 7003 is identical in all ways to S. 1514.

I might say, parenthetically, Mr. Chairman, that we are foregoing the provisions of section A and section B which constitute about four-fifths of the wording of the bill before you. Section A would have removed all time limits on leasing property by a private foundation to a disqualified person, who is defined in a way that will be brought out in the hearing.

We do not insist on that. We are willing to go along with definite time limits on the sale of property, or on the lease of the property.

Therefore, we would not need section A.

Senator BYRD. May I interrupt you for one moment? You recommend, then, eliminating section A?

Senator ALLEN. Yes, sir, but it is going to be done in another fashion, because Senator Hollings has an amendment. We agree in the purposes of his amendment, but we have a little bit different language we would like to offer. But the effect of Senator Hollings' amendment will be to eliminate A and B.

[The amendment referred to follows:]

AMENDMENT TO DRAFT PROPOSAL BY SENATOR HOLLINGS

(a) IN GENERAL.—Paragraph (2) of section 101(1) of the Tax Reform Act of 1969 (relating to private foundations savings provisions) is amended—

(1) by inserting in subparagraph (C) immediately following "December 31, 1979" the parenthetical phrase, "(or December 31, 1989, in the case of the leasing of property by a corporation, all the stock of which is owned by a private foundation, to a disqualified person if (i) the lessor corporation is not exempt from tax under subchapter F; and (ii) the disqualified person became such solely because of contributions made to the private foundation prior to October 9, 1969)" and

(2) by inserting in clause (ii) of subparagraph (F) immediately following "January 1, 1978" the words "(or January 1, 1990, in the case of a lease to which the December 31, 1989, date in subparagraph (C) applies)".

(b) EFFECTIVE DATE.—The amendments made by subsection (a) shall take take effect January 1, 1978.

Senator BYRD. The Hollings amendment, in effect, would take the place of A and B in the bill?

Senator ALLEN. It would also take the place of C and D.

Senator BYRD. Do we have a bill left?

Senator ALLEN. In effect, it will be a substitute. He has the same thought in mind that we have. Our goals are the same, but just a little different in the method of procedure and the exact wording of the amendment.

Now, section D would breathe life into a provision that would allow a sale of the stock of these intervening subsidiary taxpaying companies. The time limit expired on January 1, 1977, and we wish to forgo that provision.

We are willing that that provision lapse.

Now, I will go on with my prepared statement.

Mr. Chairman, S. 1514 was introduced because existing law contains what we believe to be an unintended, but gross, inequity which, unless corrected, after 1979 will cause constituents of ours to terminate their more than 30-year relationships with the local newspapers which they publish. I might say that two of these newspapers are in Alabama, and one is in my hometown of Gadsden. It is operated by Mr. Frank Helderman, Sr. and Mr. Frank Helderman, Jr. Mr. James Boone operates the Tuscaloosa News In Tuscaloosa, Ala.

They are community leaders and community builders, and these newspapers promote every worthwhile cause that we have in our city, county, and State. They are always seeking to better our community, to build it up, and they have succeeded admirably in their efforts to do this. They are valued public servants and we certainly do not wish the harsh provisions of this law to prevent them from engaging in arms-length negotiations on a renewal of the leases that they have on these newspaper properties and their right to operate these newspapers. What I have said about the operators in Gadsden and Tuscaloosa applies in like fashion to the operators in Spartanburg, S.C.

Illogically, the present law would permit these longstanding publishers to be replaced by outsiders, who then could reap the benefits of much of the past efforts of the present operators. This, we think, is manifestly unfair and something which should be corrected.

The chairman understands, I believe from his statement, that the operators of the newspapers lease the entire newspaper properties from taxpaying corporations which are 100 percent owned by the Public Welfare Foundation, which is a tax-exempt corporation.

But between the operators and the Public Welfare Foundation you have intervening subsidiaries, which are business corporations fully taxable in all respects.

Now, under present law, the newspaper properties cannot be sold to the present operators of the newspapers after December 31 of this year. And they cannot lease to these individuals, the properties, as they do now, after December 31, 1979. So we want to remove these prohibitions and extend this period—not remove them completely, but to extend these provisions for an additional period of 10 years, and that is the crux of the legislation.

The present operators lease the assets of the newspapers they publish from fully taxable, wholly owned, subsidiaries of a private foundation to which they technically become disqualified persons by reason

of contributions which they made to that private foundation long prior to the enactment of the Tax Reform Act of 1969. These prohibitions apply to these publishers, these operators of the newspapers, because they are said to be disqualified persons.

Now, what is a disqualified person? A disqualified person, among other things, is a person who has contributed as much as 2 percent of the total contributions that have been made to the foundation, prior to October 9, 1969.

Under the law, all contributions that had been made prior to October 9, 1969 were treated as having been made on that date and, if those contributions exceeded 2 percent—this is an amazing provision, Mr. Chairman—if those contributions which these operating companies had made to the Public Welfare Foundation exceeded 2 percent of the total contributions that had been made to this foundation, they were disqualified persons and limits were placed on the term of leases; they would be denied the right to buy the properties merely because they had made contributions to the private foundation.

Now, I will explain how these contributions came about.

These contributions were made as the result of a settlement with the Internal Revenue Service, in the case of one operator, in which the Internal Revenue Service had proposed to disallow a portion of the rental paid by that operator to the foundation as excessive.

They did make contributions that were the difference between what the IRS was willing to allow as rent and the amount that they had actually paid. They cut the rent down to the IRS figure, and the difference between that and the amount of rent that they had stipulated, they made in the form of a contribution in order to get the money to the foundation. That settlement has been followed by the other two operators.

Thus, an action clearly permissible and uncontaminating at the time it was instituted, by reason of the enactment of The Tax Reform Act of 1969, now causes the present operators of the newspapers to be subject to ouster from their own businesses, unless the proposed legislative relief is granted.

The present operators of the newspapers neither created nor control the private foundation from whose subsidiaries they lease the newspapers, and they are not related to its creator or its officers or members of its board or members of their families. Thus, the evils at which The Tax Reform Act of 1969, apparently, was aimed are not present here.

Present law would prohibit the sale of the papers by the foundation to the present operators after 1977. The foundation does not want to sell these papers, but if they are to be sold to the present operators, they have got to be sold before the end of the year.

If they are given another 10 years, the situation may develop where both sides might want to enter into a purchase and sale agreement,but right now, they do not want to. Consequently, time is rapidly running out on their relationship, thereby compelling this request for immediate action.

The deadlines on the two acts are different. Under existing law, the deadline for selling the properties by these subsidiaries to the present operators expires with this year. They can lease to anyone under the sun, but they cannot lease to these fine people, to these successful

operators, who are an asset and a credit to their respective towns, beyond December 31, 1979. They can lease to anybody else, but not to these fine people who are operating these newspapers in a highly credible fashion.

I am advised that this bill should have no effect upon Federal revenue, and I do not know of any other group that would be affected by its enactment.

You have subsidiary companies that own the properties, and they are fully taxable, their income is taxable, and there would be no loss of Federal revenue.

Subsection (a) of the bill is intended, under these limited circumstances, to remove the leasing arrangements between the present operators and the Foundation's subsidiaries from the self-dealing prohibitions of the present law. As I stated, we are willing to drop that part of the bill.

Subsections (b), (c) and (d) of the bill are intended to extend to 1990, the time provided by present law, within which these arrangements or sale to the operators of the newspaper properties or their shares are permissible.

As I stated, we are dropping subsection (b) which allows the foundation to sell some of its shares in the subsidiary companies, but that time has already expired. It expired the first of this year, and we are now seeking to breathe life into that right that has gone by the board, and we are willing for that to take place.

Senator Hollings, while not a cosponsor of S. 1514, is equally interested in helping resolve this complex and unique problem. He has communicated his interest and his ideas to you and he and I are in complete agreement on the goals.

Senator BYRD. Did the committee understand correctly that Senator Hollings supports the draft amendment to his amendment?

Senator ALLEN. I have been advised that he does support it. Mr. Friedman assures me that that is correct. There have been negotiations backward and forwards for some days on these provisions. I would like to explain why the change in the Hollings amendment is necessary from a practical point of view.

I do wish to suggest a revision in the Hollings draft, not inconsistent with our joint goals. His amendment would allow an extension of time in the areas covered by the bill for persons disqualified solely because of contributions to the foundation made before October 9, 1969, where such contributions were less than 12 percent instead of 2 percent of the contributions received by the foundation up to October 9, 1969.

As I stated, at the outset, a disqualified person, by definition among other phases of the definition, is a person who has contributed 2 percent or more of the contributions received by the foundation, and all contributions made before October 9, would be treated as having been made on October 9, 1969, and if the sum total of the contribution by this person were 2 percent or more of the overall contributions, then he would be a disqualified person.

Well, these contributions that I referred to, that are given in lieu of rent, aggregate to considerably more than 2 percent of the overall contribution to the foundation.

Senator Hollings, having been advised of what the contributions of the operators were, came up with a 12-percent figure, apparently because he felt that was high enough to take care of the contributions. That is the problem, Mr. Chairman.

The main source of contributions were not cash contributions, but they consisted of bargain sales of these newspaper properties by the then owner, which was General Newspapers, Inc., to the foundation. The sponsor of the foundation controlled General Newspapers, so that he had these properties sold at less than the market value, bargain sales. The difference between the sales price and the market value would, under the tax law, be a contribution, so that is where the contributions came from.

Now if we are required to show that the contributions we made—and I am sure Mr. Friedman will tell you the exact amount of the contributions by each paper—if we are required to prove that our contributions were less than 12 percent of all of the contributions received by the foundations, then we would have to show what these papers were worth back in the 1950's when they were sold.

How in the world can you establish in the year 1977 what newspaper properties were worth back in the early 1950's? That is the problem we have.

It raises evidenciary problems, problems of proof to show what that value was. If the tax people are able to show that there was a lesser difference, that newspapers were worth less, then that contribution would be less and therefore the percentage of that contribution by the operators would be raised, and you might not get the benefit of the 12-percent provision.

What would we have if the bill was approved? The bill would extend until January 1, 1990, the right of this foundation to sell to these operators at fair market value and in armslength transactions, these newspaper properties, that they have been operating for some 30 years.

Second, it would extend to the same date, through December 31, 1989, the limit that the subsidiary companies could lease these properties to the present operators. Senator Hollings has approved this approach. In other words, if the bill is passed, the operators would have until January 1, 1990, to either buy the properties or continue to lease them up until that date.

Senator BYRD. 1990?

Senator ALLEN. 1990, yes.

Senator BYRD. Let me, if I may, Senator Allen, state it the way I understand it, and see if my understanding is correct.

As the law now stands, the deadline for selling expires at the end of 1977?

Senator ALLEN. That is correct.

Senator BYRD. The deadline for leasing expires at the end of 1979?

Senator ALLEN. That is correct.

Senator BYRD. This substitute proposal would extend the deadline in both cases to December 31, 1989?

Senator ALLEN. That is correct. That is all there is to it.

With that, I conclude my testimony.

Senator BYRD. Thank you very much, Senator Allen.

Senator ALLEN. Mr. Friedman also wishes to speak.

Senator BYRD. We have other witnesses, including the Tax Legislative Counsel of the Department of the Treasury.

I know that Senator Allen may have other commitments——

Senator ALLEN. I would like to stay as long as I can.

Senator BYRD. The questions that I have, I suppose should really be addressed to Mr. Friedman, or Mr. Boone and Mr. Helderman.

[The prepared statement of Senator Allen follows:]

STATEMENT OF SENATOR JAMES B. ALLEN

Thank you, Mr. Chairman.

On May 13, 1977, Senator John Sparkman and Senator Strom Thurmond joined me in introducing S. 1514 to amend Section 4941 of the Internal Revenue Code of 1954 and Section 101(1)(2) of The Tax Reform Act of 1969.

On May 9, 1977, Congressman Tom Bevill of Alabama on behalf of himself and Congressman James R. Mann of South Carolina, Congressman Kenneth Holland of South Carolina and Congressman Walter Flowers of Alabama, introduced H.R. 7003 in the House of Representatives. H.R. 7003 is identical in all ways to S. 1514.

Mr. Chairman, S. 1514 was introduced because existing law contains what we believe to be an unintended, but gross, inequity, which, unless corrected, after 1979 will cause constituents of ours to terminate their more than 30-year relationships with the local newspapers which they publish. Illogically, the present law would permit those long-standing publishers to be replaced by outsiders, who then could reap the benefits of much of the past efforts of the present operators. This, we think, is manifestly unfair and something which should be corrected.

The present operators lease the assets of the newspapers they publish from fully taxable, wholly owned, subsidiaries of a private foundation to which they technically became disqualified persons by reason of contributions which they made to that private foundation long prior to the enactment of The Tax Reform Act of 1969. These contributions were made as the result of a settlement with the Internal Revenue Service, in the case of one operator, in which the Internal Revenue Service had proposed to disallow a portion of the rental paid by that operator to the foundation as excessive. The contributions were then made in lieu of the disallowed amount. That settlement has been followed by the other two operators. Thus, an action clearly permissible and uncontaminating at the time it was instituted, by reason of the enactment of The Tax Reform Act of 1969, now causes the present operators of the newspapers to be subject to ouster from their own businesses, unless the proposed legislative relief is granted. The present operators of the newspapers neither created nor control the private foundation from whose subsidiaries they lease the newspapers, and they are not related to its creator or its officers or members of its board or members of their families. Thus, the evils at which The Tax Reform Act of 1969, apparently, was aimed are not present here.

Present law would prohibit the sale of the papers by the foundation to the present operators after 1977. Consequently, time is rapidly running out on their relationship, thereby compelling this request for immediate action.

I am advised that this bill should have no effect upon Federal revenue, and I do not know of any other group that would be affected by its enactment.

Subsection (a) of the bill is intended, under these limited circumstances, to remove the leasing arrangements between the present operators and the Foundation's subsidiaries from the self-dealing prohibitions of present law. Subsections (b), (c) and (d) of the bill are intended to extend to 1990, the time provided by present law, within which these arrangements or sale to the operators of the newspaper properties or their shares are permissible.

Senator Hollings, while not a co-sponsor of S. 1514, is equally interested in helping resolve this complex and unique problem. He has communicated his interest and his ideas to you and he and I are in complete agreementon the goals.

I do wish to suggest a revision not inconsistent with our point goals. His amendment would allow an extension of time in the areas covered by the bill for persons not disqualified solely because of contributions to the Foundation made before October 9, 1969, where such contributions were less than 12 percent instead of 2 percent of the contributions received by the Foundation up to October 9, 1969. Under this definition the newspaper operators would in actuality not be disqualified persons because their contributions were less than 12 percent.

But since a large portion of the contributions received by the Foundation were in the form of bargain sales to it of the newspapers involved, it will be exceedingly difficult to prove the difference between the sales prices of the papers and the actual market value (which difference would count as contributions). This is especially true since the sales took place back in the fifties. Mr. Friedman, Attorney for the Foundation, who is present, has prepared an amendment that accomplishes what Mr. Hollings desires without causing the evidentiary problems that Mr. Hollings' amendment might cause. I offer this amendment for the Committee's consideration.

We are unified in our interest in setting right a matter which could, otherwise, cause a grave injustice to the operators of these newspaper properties.

Mr. Chairman, I thank you for your courtesy.

Senator BYRD. At this time, I think we should hear from Mr. Daniel Halperin, Tax Legislative Counsel for the Department of the Treasury.

STATEMENT OF DANIEL HALPERIN, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. HALPERIN. Mr. Chairman, the Treasury Department is greatful that it is been given an opportunity to present its views on S. 1514, a bill that would amend section 4941 of the Internal Revenue Code and section 101(1)(2) of the Tax Reform Act of 1969.

I think that I can skip the statement of facts in my prepared statement, and also the description of the bill, because I think it has been adequately brought out in Senator Allen's testimony.

Senator BYRD. We can publish your full statement in the record, and you may proceed.

Mr. HALPERIN. A charitable organization whether it be a public charity or a private foundation, must not operate to the benefit of private individuals. Prior to passage of the Tax Reform Act of 1969, this principle was applied to dealings between a charity and related parties by using the "prohibited transactions" test of the code section 503(b). Generally, this standard demands that such dealings accord with the type of bargain that would be struck in an arm's length transaction.

In enacting the Tax Reform Act of 1969, Congress made the decision that the subjective arm's length test of section 503(b) was not satisfactory in the case of private foundations. Congress chose instead to eliminate completely self-dealing between a foundation and certain "disqualified persons" through the adoption of the self-dealing taxes under section 4941.

It apparently believed that the interference with particular legitimate transactions was outweighed by the elimination of actual and potential abuse. The statutory self-dealing standards for private foundations are thus objective, inflexible rules which imply rejection of a case-by-case analysis.

However, like any objective standards, the self-dealing provisions can apparently lead to harsh results, especially in view of the fact that an individual furnishing only 2 percent of a foundation's contributions is classified as a "disqualified person." Transactions will run afoul of section 4941 even though a subjective evaluation would suggest that a particular "disqualified person" had little control over the foundation's operations and that the transaction involved no overreaching.

The lessee-operators in this case would appear to be at the outer spectrum of disqualified persons encompassed by the 1969 act. Thus (a) the lessees were not the major contributor to the foundation; (b) the newspaper leases were in existence long before the lessees made any donation to the foundation; (c) the contributions in this case were apparently offered by the newspaper operators as substitutes for rental payments; and (d) the consequences of such a recharacterization of payments to the foundation were unforeseen.

Senator BYRD. I am not totally clear as to what you said. As I understand it the Treasury does not oppose the proposal just made by Senator Allen, which would be to substitute for the original bill.

Mr. HALPERIN. We have submitted some draft language, which is attached to my statement, which essentially sets up two conditions, the one in Senator Hollings amendment and the one in Senator Allen's amendment that he has just introduced requiring both that the payments be a substitute for rent and that they be less than 12 percent of total contributions.

We were not aware of any problem involving the 12-percent test. Presumably, we would have to talk about it further.

Personally, I would like to see some percentage limitation, because I think it is important to distinguish this case on the basis that these people are not the major contributors. If there is no ceiling, conceivably we could be sanctioning a transaction between the foundation and the major contributor to it, because there is no limitation in the amendment that was just introduced, as I understand it, on the size of the contribution or the percentage of contributions that would be made by the lessee.

If it were not 12 percent, perhaps it could be some other number that people would feel more comfortable with. As long as there is an indication that what we have here are minority contributors——

Senator BYRD. Are you speaking of future contributions?

Mr. HALPERIN. I am speaking of past contributions.

The question is, what is the value of the contributions made by the operators of the newspapers as compared to the contribution which is made by the founder of the foundation, and I think that the thing that distinguishes this case perhaps from a number of other ones, these are minority contributors, presumably having no control over the actual day-to-day operation of the foundation, and Senator Hollings amendment does pick that up, and I think we would like to see if we could have some restriction on the size of the contributions.

As I said, we were not aware before a few minutes ago that there was a problem.

Senator BYRD. I must say that I am not clear on this. The restriction is on the size of the contributions, but the contributions have already been made.

Mr. HALPERIN. Restriction in the exception, to the prohibition of leases between the foundation and people who contributed to a foundation. Something less than—we say less than 12 percent of the total contributions received by the foundation before October 1969. If that number is a problem, maybe it could be to people who contributed less than 15 percent of the total contributions received by the foundation, some number that would indicate that the lease could not continue between the foundation and 100 percent contributors, which I think that Senator Allen's amendment would permit.

Senator ALLEN. Mr. Chairman, may I address the point?

Senator BYRD. Yes.

Senator ALLEN. The present law says that if a person has contributed 2 percent or more of the total contributions received by the foundation, that person would be a disqualified person and subject to these time limitations on disposition of assets and lease, and the Hollings amendment raises that for the purpose of this situation to 12 percent.

The trouble is the contributions made by Mr. Marsh, the founder of this foundation, were not in the form of cash. The amounts that the operators paid, they are down to the exact dollar, they are definite, but since the contributions that Mr. Marsh made, or his company, General Newspaper, made, were really in the form of selling the properties at less than fair market value. So this contribution would be figured at the difference between the sales price and the fair market value.

So that gets you to the point, the hazy point, the uncertain point of proving what these papers were worth back in 1950. And I submit that that is going to be very difficult to ascertain what they were worth, what the good will was worth.

You can figure out what the physical assets were worth, but newspapers sell a whole lot more than the physical assets.

Now, if the IRS was able to say that these papers were worth just a little bit over the sale price, then that would cut down the amount of Mr. Marsh's contributions, thereby raising the percentage of the overall contributions as a contribution by the operators.

In other words, if the difference between the fair market value and the sale price was $10 million, let us say, then these contributions that they made would not be very large in percentage. But if we say this difference was only $2 million, then the contribution they made could exceed the 12 percent or the 15 percent that Mr. Halperin suggests; unless you are going to have more tax investigation, if you keep adding a definite figure on account of the uncertainty of the value of Mr. Marsh's contributions.

Is that correct, Mr. Friedman?

STATEMENT OF LYMAN G. FRIEDMAN, ESQ., WASHINGTON, D.C., ACCOMPANIED BY FRANK HELDERMAN, SR., PUBLISHER, THE GADSDEN TIMES, GADSDEN, ALA.; JAMES B. BOONE, JR., PUBLISHER, THE TUSCALOOSA NEWS, TUSCALOOSA, ALA.; AND FRED D. MOFFITT, PUBLISHER, SPARTANBURG HERALD & JOURNAL, SPARTANBURG, S.C.

Mr. FRIEDMAN. That is correct, sir.

If I may, Mr. Chairman, the gifts were made back in the early fifties. The present Internal Revenue Code requires that property be valued at its fair market value on the date that the gifts were made, for definitional purposes of self-dealing and substantial contributor. Thus, we would have to show the value of these three newspapers back in the early 1950's.

Our ability to produce competent witnesses who would know the values of newspapers back in the fifties becomes increasingly difficult some 27 years later.

We believe that the amount of Mr. Marsh's gifts were of sufficient value so that the percentages given by the three present operators would be well below 15 percent, but our ability to produce competent evidence on that point is not certain in our own minds, only because of the lapse of time.

We believe, for example, that when the newspapers were sold to the foundation, for something approximating $1.2 million, at the time the parties thought that was worth about $2.5 million, but our ability to prove that may be difficult.

Also, the ability to produce the underlying records that go to value and all that sort of thing may be difficult, particularly in the situation where, as we understand it, we did not represent Mr. Marsh at that time. We are told that Mr. Marsh did not even claim a tax deduction for the charitable contribution, so that the records are extremely uncertain as far as we know at this time, and it is only that evidentiary problem that causes us to question the imposition of a precise percentage.

Senator ALLEN. If I may venture to suggest, Mr. Chairman, the chairman himself may have difficulty proving the value of some of his newspaper properties back in the 1950's at this time.

Senator BYRD. Yes; I think it is very difficult to make a determination.

How important, and why, Mr. Halperin?

Mr. HALPERIN. I think the key thing, Mr. Chairman—I do not necessarily insist that any numbers be in, but the key thing is to make certain that these people are not the founders and controlling parties in the foundation. I think that is certainly true.

I am sure that language could be worked out that would indicate that. That would be satisfactory.

Senator BYRD. Am I correct in assuming that all three newspaper properties were put into the foundation at the same time?

Mr. FRIEDMAN. They were put in succeeding years: 1952, 1953, and 1954, I believe, were the years in which they were sold to the foundation by Mr. Marsh or the corporation that he controlled in each instance. They were bargain sales. He tried it with one. He liked the way it operated. He liked the work it was doing, and when he found it was successful, he did it with others.

Senator BYRD. I have an organizational chart here sketched for me by the staff. It has Public Welfare Foundation, and then it owns the Spartanburg Herald; then the Spartanburg Herald is then leased to the Newspaper Management Corp.?

Mr. FRIEDMAN. That is correct.

Senator BYRD. The same situation with the Gadsden Times, leased to the Gadsden Times Publishing; the Tuscaloosa News, the Tuscaloosa Newspapers, Inc.

Mr. FRIEDMAN. If I may cut in at this point and give a little background.

Mr. Marsh was a newspaper man. He had made his fortune in the newspaper business.

He had had interests in the three newspapers that are involved. It was his desire to let his employees operate those papers, put full management and control, editorial control, in the operators.

The foundation was to have no part of that. The foundation was simply to receive a share of the income from those newspapers to be used entirely for charitable purposes.

Since the creation of the Public Welfare Foundation in the early 1950's, over $12 million has been given in recognized charitable grants by the Public Welfare Foundation. The source of those funds has been its share of rent for the three newspapers, the rent coming from the operating companies that were formed by the former employees of those newspapers.

Originally, the newspapers were owned by the foundation and the operators paid 90 percent of the net profit of the newspapers to the foundation as rent. In 1966, the Internal Revenue Service thought that the foundation should not own the newspapers, and as a part of the settlement of that matter, the foundation transferred the ownership of all of the assets of the three newspapers to three wholly owned, fully taxable, subsidiaries.

The subsidiaries have continued to lease on renewals of leases to the operating companies. The operating companies, as I mentioned, are owned by former employees of these newspapers. They have been the operators now for about 30 years if you add on the employment period that came before the creation of the foundation.

In the matter that we have discussed a moment ago, when the Internal Revenue Service questioned the deduction of the rent paid by one of the operating companies, they were then paying 90 percent of the profit as rent. It was settled by their agreeing to deduct only 75 percent as rent. The operators then agreed on their own and voluntarily that they would give another 15 percent as a charitable contribution.

In recent years we have turned that around to a percentage of gross, but it is the same theory and we try to approximate those same percentages, but there is no longer a voluntary contribution involved at all from these people.

These same men have operated these same papers for approximately 30 years and are now faced with imminent ouster. Possibly we will have to lease to somebody else if we do not get this relief, which would mean further concentration of newspaper control in a smaller group, because it would mean leasing these newspapers to some qualified, probably chain, and outside of the local scene.

These are local people who have been operating them for all these years. We would have to bring in outsiders and put these newspapers in the hands of the chains. We are trying to avoid that. We do not think that this is the time for us to sell.

As we understand it, from the best advice we can get, that perhaps the chairman has seen the articles that have appeared in such papers as the New York Times and Barron's had another article, there have been a number of them, on the desirability of the ownership of newspaper stocks as an investment.

This has been particularly true of the ownership in the Southeast part of the country. We think for us to sell at this time would be premature. Obviously the foundation is not going to suffer. The officers of the foundation will not suffer, but those persons who would be the natural objects of the charitable grants that are being made by the foundation are the ones that would suffer.

If we were required to sell prematurely, on the other hand, the fellows who have been operating the papers all of these years, who now are beginning to realize the benefit of what they have done for 30 years, would certainly be ousted from that benefit and would suffer similarly, were we compelled to lease to others.

It is for those reasons that we think we have an equitable basis for the relief that we are requesting and what we are asking at this time is for a 10-year extension of the ability to maintain these people on an arms-length lease to the present operators and the ability at the termination of those leases to be able to sell to them, because they are the natural persons to make that purchase.

We have talked with the staff of the joint committee and, as I understand Mr. Halperin, they would have no objection to trying to find suitable language, if you will, to narrow the definition of substantial contributors in such a way that we will be able to satisfy it.

I think it is a matter of language more than purpose. We do, however, as I repeat—forgive me for repeating—have the evidentiary problem, if we are faced with a precise percentage. We do agree that we would have no problem on the concept of excluding the creator, from the relief, because that would be Mr. Marsh or any member of his family or anything of that sort, and none of these operators fall into that category.

Senator BYRD. In the early part of your statement that you just made, did you say that the Public Welfare Foundation does not own the newspapers now?

Mr. FRIEDMAN. It does not operate the newspapers. Public Welfare Foundation owns three wholly-owned, fully taxable subsidiary corporations. Those subsidiary corporations own all of the assets, and they in turn enter into leases with the operators. The operators are the publishers; they are present here.

Mr. Boone from Tuscaloosa; Mr. Moffitt, of Spartanburg; and the Heldermans from Gadsden.

Senator BYRD. The Public Welfare Foundation owns the Spartanburg Herald Publishing Co.

Mr. FRIEDMAN. It owns the corporation which owns the assets of the Spartanburg paper. The publishing company itself, the company that does the publishing, is owned by Mr. Buchheit and Mr. Moffitt is its publisher. They are leasing the assets from the Spartanburg Herald Corp.

Senator BYRD. Owned by the Public Welfare Foundation.

Mr. FRIEDMAN. That is correct, Mr. Chairman.

The Public Welfare Foundation and the Spartanburg subsidiary of Public Welfare do not take any part in the editorial policy or the management or operation of the business. They take stockholders' overview of the operation.

But all of the operations and editorial policy are in the hands of Mr. Moffitt and his people, using Spartanburg as an example. In each instance, that same is true.

Senator BYRD. I assume that the trustees of the Public Welfare Foundation are entirely separate and different individuals from those who have the operating company?

Mr. FRIEDMAN. That is true. There is no relationship in any way between the officers, directors of the foundation and the officers and shareholders of the operating companies.

Senator BYRD. The operating company, then, leases the newspaper, pays to that newspaper corporation a certain rent.

Mr. FRIEDMAN. That is correct.

Senator BYRD. Which in turn goes to the foundation?

Mr. FRIEDMAN. That is correct.

Senator ALLEN. After taxes.

Senator BYRD. Both of these corporations are taxable?

Mr. FRIEDMAN. All three of the leasing corporations, they receive a percentage of gross income received by the operators. That percentage is fully taxed at regular corporate rates in the subsidiary. The balance remaining, after reserves, and that sort of thing, is paid up as dividends to the foundation. Over the past 5 years, roughly $4 million has been paid.

Senator BYRD. I assume that the amount paid to lease the property is a figure that necessarily needs to be approved by the Internal Revenue Service.

Mr. FRIEDMAN. It has been noted for many years. I would not want to imply that the Internal Revenue Service has put its stamp of approval on it. As far as I know, there has been no question raised on the rent, since the event that was described back in the early fifties—excuse me, about 1959, where they said Spartanburg was paying an excessive rent, and the rent was reduced from 90 percent of profit to 75 percent.

The 90 percent has been the basis of the relationship since then, but we have turned it to a percentage of gross income, tried to translate to it an approximate result, rather than getting a percentage of net profit. This change was made in order to further remove the foundation and its subsidiaries from the day-to-day operational problems and expenses of the newspapers.

Senator BYRD. Would it not be the higher the lease, the more the operating company pays to lease the foundation, the more going to the foundation?

Mr. FRIEDMAN. Ultimately, yes, sir.

Senator BYRD. Why would there be a complaint about it? It would seem to me that the Internal Revenue would complain the other way, if they were going to complain at all.

Mr. FRIEDMAN. Internal Revenue was examining the returns of the operating company and questioning the size of the deduction that was taken for the payment of rent. I must presume—I was not a party to any of that—that it was on the basis of ordinary and necessary and reasonable, and they thought a 90-percent rent was excessive.

Mr. HALPERIN. It depends on which side of the transaction the Service is looking at.

Mr. Chairman, if I may make one more point, we have been talking up to now about an extension of the period up until December 31, 1989. Treasury does believe that it may be preferable to examine this without regard to any time limit. For the reasons that I have in my statement, that Treasury believes that this approach is preferable to a general extension of the various grandfather clauses, which have already provided generous transition rules for private foundations.

It may also be preferable to a narrowly defined exception to the grandfather clauses, because it will not set a precedent which would indicate that in certain cases at least, Congress is willing to consider allowing more time to unravel the self-dealing transactions without any special showing of the inadequacy of the 10-year period originally granted.

A question, I guess: Do we, by extending the period in this case—which obviously has very special circumstances which is very hard to duplicate, in any event—do you, by extending the time limit in this case open yourself to a great many other requests from other people who have been living under the grandfather clause for 10 years and will now see this as an opening wedge for possibly extending it?

As I see the equity here, it is not that they have any particular problem with the time limit. It is that this particular transaction should never have been caught by the foundation provisions in the first place.

If that is the committee feelings about it, perhaps less precedent may be created by not extending the grandfather clause, but rather permanently changing the definition of substantial contributor, so as not to treat these operators of the newspapers as substantial contributors for any purpose.

Senator BYRD. I understood you earlier to indicate that you and the interested parties will be getting together to try to work out some additional language to Senator Hollings' bill. This is something that would be considered in your conferences.

Mr. HALPERIN. We think we should be able to do that, Mr. Chairman.

Senator BYRD. It may be that the committee will need to seek some additional information after we have had a chance to study the record. Am I correct in my statement that Treasury feels that there would be neither revenue loss nor gain from this measure?

Mr. HALPERIN. I think that is true, Mr. Chairman.

Senator BYRD. Is there a possibility that parties not contemplated under the bill could benefit from this measure, or is it narrowed in scope to this one particular corporation?

Mr. HALPERIN. I suppose that does depend on how specific the final language gets, although it is difficult to believe that there would be many other situations in which people made contributions in lieu of rent. I am not sure what the Internal Revenue Service's practice was back in 1959. I suspect this is the unique case.

Mr. FRIEDMAN. If I may, Mr. Chairman, I have had one phone call since the bill was originally introduced in early May. I had one inquiry from one law firm asking about it. I told them what was in the statement that was attached to the bill when it was originally introduced. They said that theirs was not that similar to our situation. I have heard from no one else, so that I can only tell you that I know of no one else who has a similar situation.

Senator BYRD. I might say that this subcommittee followed the practice which we established as soon as this subcommittee was created, namely in regard to any special legislation, before a hearing would be held on it, the gist of the legislation and the intended beneficiaries of such legislation would be inserted in the Congressional Record in advance, which in this case was 10 days ago.

I think it is important that in these narrowly defined tax areas that it be clear that all the facts be brought out in advance before the hearing and that everybody will have the opportunity to see these facts along with whatever facts that are brought out at the hearing.

I thank you gentlemen very much. After studying the record, there may be several points of fact and additional information we may be seeking from you.

Thank you.

Mr. FRIEDMAN. On behalf of the operators, we would be glad to answer any questions there may be.

Thank you.

[The prepared statement of Mr. Halperin follows:]

STATEMENT OF HON. DANIEL I. HALPERIN, TAX LEGISLATIVE COUNSEL

Mr. Chairman and members of this subcommittee, I am grateful that the Treasury Department has been given an opportunity to present its views on S. 1514, a bill that would amend section 4941 of the Internal Revenue Code and section 101(1)(2) of the Tax Reform Act of 1969.

RELEVANT PROVISION RELATING TO PRIVATE FOUNDATIONS

The Tax Reform Act of 1969 contains a series of restrictions on private foundations. The provision primarily at issue today is Code section 4941, which imposes taxes on self-dealing. Generally, a person found to be self-dealing, within the meaning of section 4941, is liable initially for a tax equal to five percent of the amount involved with respect to each act of self-dealing. An additional tax equal to 200 percent of the amount involved is imposed on the self-dealer if the proscribed act is not corrected in a timely manner.

Included within section 4941's definition of "self-dealing" is a direct or indirect sale or lease of property between a private foundation and a "disqualified person." It is this provision that raises the tax problems addressed by S. 1514.

FACTS UNDERLUING S. 1514

On the basis of information inserted in the Congressional Record by the sponsors of the bill, we understand that Public Welfare Foundation, Inc., owns all of the stock of three corporations, The Gadsden Times, Inc., the Tuscaloosa News, Inc., and The Spartanburg Herald and Journal, Inc. These three wholly-owned subsidiaries have, for a substantial period of time, leased all of the assets of three newspapers to operating companies. Apparently, after the Internal Revenue Service suggested that the original rentals specified in the lease agreement were unreasonably high, the newspaper operators decided to make charitable donations to the Foundation in exchange for reduced rentals.

Since each of the operators contributed more than $5,000 and more than two percent of the total contributions to the Foundations as of October 31, 1969 (the end of the fiscal year which includes October 9, 1969), each operator is considered to be a "substantial contributor" to the Foundation, within the meaning of Code section 4946(a)(1)(A). Therefore, the operators are "disqualified persons" and their leasing arrangements with the private foundation (through its subsidiaries) fall within the statutory definition of "self-dealing." However, a "grandfather" clause in the Tax Reform Act of 1969 defers application of the self-dealing taxes to these leasing arrangements until taxable years beginning after December 31, 1979.

EFFECT OF S. 1514

S. 1514 would make the following changes in the self-dealing rules:

(1) It would exempt permanently from the self-dealing taxes the leasing of property to a disqualified person by a wholly-owned subsidiary of a private foundation where (a) the lease is pursuant to a binding contract in effect on October 9, 1969, (b) the leasing arrangement at no time constitutes a prohibited transaction under Code section 503(b), (c) the lease terms are no more favorable to the disqualified person than such terms would be in an arms-length transaction, (d) the lessor is not a tax-exempt corporation, and (e) the disqualified person obtained that status solely because of contributions made to the private foundation prior to October 9, 1969.

(2) The 1969 Act provides a grace period for the termination of a preexisting lease between a private foundation and a disqualified person as long as the lease is not disadvantageous to the foundation. The bill would extend the expiration of this grace period from December 31, 1979 to December 31, 1989.

(3) Another grandfather clause currently permits property, leased by a private foundation to a disqualified person at the time of passage of the Tax Reform Act of 1969, to be sold for at least fair market value to the disqualified person. The deadline for such a sale would be extended by the bill from December 31, 1977 to December 31, 1989.

(4) Under still another grandfather clause, a private foundation had until January 1, 1977 to sell stock to a disqualified person even though the Act's transition rules did not require divestiture at that time in order to avoid the taxes on excess business holdings imposed by section 4943. This deadline would be extended by the bill until January 1, 1990.

TREASURY COMMENTS

A charitable organization, whether it be a public charity or a private foundation, must not operate to the benefit of private individuals. Prior to passage of the Tax Reform Act of 1969, this principle was applied to dealings between a charity and related parties by using the "prohibited transactions" test of Code section 503(b). Generally, this standard demands that such dealings accord with the type of bargain that would be struck in an arm's-length transaction.

In enacting the Tax Reform Act of 1969, Congress made the decision that the subjective arm's length test of section 503(b) was not satisfactory in the case of private foundations. Congress chose instead to eliminate completely self-dealing between a foundation and certain "disqualified persons" through the adoption of the self-dealing taxes under section 4941. It apparently believed that the interference with particular legitimate transactions was outweighed by the elimination of actual and potential abuse. The statutory self-dealing standards for private foundations are thus objective, inflexible rules which imply rejection of a case-by-case analysis.

However, like any objective standard, the self-dealing provisions can apparently lead to harsh results, especially in view of the fact that an individual furnishing only 2 percent of a foundation's contributions is classified as a "disqualified person". Transactions will run afoul of section 4941 even though a subjective evaluation would suggest that a particular "disqualified person" had little control over the foundation's operations and that the transaction involved no overreaching.

The lessee-operators in this case would appear to be at the outer spectrum of "disqualified persons" encompassed by the 1969 Act. Thus, (a) the lessees were not the major contributor to the foundation; (b) the newspaper leases were in existence long before the lessees made any donation to the foundation; (c) the "contributions" in this case were apparently offered by the newspaper operators as substitutes for rental payments; and (d) the consequences of such a recharacterization of payments to the foundation were unforeseen.

Therefore, the Treasury would not object to special consideration of this case provided the grant of relief is drawn more narrowly than S. 1514. I am submitting with my statement proposed language that would remove from the definition of "substantial contributor" a person who became a substantial contributor solely because of contributions prior to October 9, 1969 which totalled less than twelve percent of the total contributions to the foundation as of that date, and where such contributions were made to the private foundation in lieu of rent originally required by a leasing arrangement. Treasury believes that this approach is preferable to a general extension of the various grandfather clauses, which have already provided generous transition rules for private foundations. It may also be preferable to a narrowly defined exception to the grandfather clauses because it will not set a precedent which would indicate that in certain cases at least Congress is willing to consider allowing more time to unravel self-dealing transactions without any special showing of the inadequacy of the 10-year period originally granted.

Suggested Treasury Proposal in Lieu of S. 1514

Section 4946(a)(2) of the IRC is amended to read as follows:

(2) Substantial Contributors: For purposes of paragraph (1), the term "substantial contributor" means a person who is described in section 507(d)(2) except that for purposes of section 4941 (relating to self-dealing) a person shall not be deemed a substantial contributor if:

(A) Pursuant to a binding contract in effect on October 9, 1969 such person leased property from a corporation whose stock is solely owned by a private foundation which lease at no time constituted a prohibited transaction (within the meaning of section 503(b) or the corresponding provisions of prior law),

(B) The contributions made by such person to the private foundation were made in lieu of rent originally required by such leasing arrangement, and

(C) Such contributions were made prior to October 9, 1969 and totaled less than 12 percent of the total contributions and bequests received by the foundation before the close of the taxable year which includes such date.

Senator Byrd. The committee will stand in recess, subject to the call of the Chair.

[Thereupon, at 3 p.m. the subcommittee recessed to reconvene at the call of the Chair.]

APPENDIX

Description of S. 1514; A Bill Relating to Private Foundation Leasing of Business Assets Listed for a Hearing; Prepared for the Use of the Committee on Finance by the Staff of the Joint Committee on Taxation

I. Introduction

The bill described in this pamphlet (S. 1514) has been scheduled by the Subcommittee on Taxation and Debt Management of the Committee on Finance for a hearing on July 25, 1977. The bill relates to leasing business assets by private foundation to a "disqualified person."

In connection with this hearing, the staff of the Joint Committee on Taxation has prepared a description of the bill. The description indicates the present law treatment, the issue involved, an explanation of what the bill would do, the effective date of the bill, and the bill's revenue effect.

II. Description

S. 1514—Mr. Allen (for himself, Mr. Sparkman, and Mr. Thurmond)

Private Foundation Leasing of Business Assets to Disqualified Persons

Present law

Under present law (sec. 4941 of the Internal Revenue Code), private foundations are generally prohibited from engaging in transactions with disqualified persons. The prohibited acts (referred to as acts of "self-dealing") include the "sale or exchange, or leasing, of property between a private foundation and a disqualified person". A "disqualified person" is defined to include anyone who is a "substantial contributor" to the foundation. A "substantial contributor" includes any person who has contributed more than $5,000 to the foundation, if the total contributions from that person exceed 2 percent of the total contributions received by the foundation. Once a person is a substantial contributor, he remains so forever.

These provisions were added by the Tax Reform Act of 1969. In order to permit the orderly termination of arrangements existing in 1969 between private foundations and their disqualified persons, the 1969 Act (sec. 101(l)(2)(C)) permitted then-existing leasing arrangements to continue for up to 10 years (through 1979), but only so long as the foundation was not disadvantaged by the terms of the lease. In addition, the Tax Reform Act of 1976 amended the 1969 Act to allow these permitted transitional leases to be terminated by a sale of the leased property by the foundation to disqualified persons. This provision (see 101(l)(2)(F) of the 1969 Act) required that any such sale must be completed before January 1, 1978.

Another provision of present law (sec. 4943) limits the percentage of ownership which a foundation (and all its disqualified persons) can hold in any single business. In general, the combined business ownership of a foundation and disqualified persons in any business may not exceed 20 percent (35 percent ownership by the foundation and disqualified persons together is permitted where an unrelated group is shown to be in control of the business). These provisions were also added by the Tax Reform Act of 1969, and include transitional rules to allow foundations an adequate opportunity to dispose of their then-existing holdings. Under these transitional rules, where a foundation itself owned more than 95 percent of the voting stock in a business in 1969, an initial transitional period of 20 years (generally through May 26, 1989) was provided for the foundation to reduce its combined ownership (together with disqualified persons) to 50 percent. Where lesser percentages were owned in 1969, transitional periods of 10 and 15 years were provided. The Act also allowed foundations to dispose of their excess holdings by sales to disqualified persons (sec. 101(l)(2)(B) of the 1969 Act.)

In summary, the Congress—

(1) provided restrictions on foundation involvement in onwnership of businesses and forbade completely continuing leasing relationships with disqualified persons,

(2) provided transitional periods for disposing of existing businesses and terminating continuing relationships with disqualified persons, and

(3) permitted self-dealing sales only if they would facilitate the disposition of excess business holdings or the termination of continuing lease relationships.

Issues

The bill presents several related issues:

First, whether there should be a permanent "grandfather clause" for certain cases permitting indefinite continuation of a lease of property between a private foundation and disqualified persons.

Second, whether the present law's 10-year period for terminating leases in existence in 1969 should be extended an additional 10 years (through 1989).

Third, whether a private foundation should be permitted to sell such leased property to a disqualified person at any time through the end of 1989.

Explanation of the bill

The bill would permit, in certain circumstances, the indefinite continuation of a lease between a private foundation and a disqualified person if the lease was in existence on October 9, 1969. Subsequent renewals of such a lease would not disqualify the lease for purposes of this bill. This would be permitted only if the following conditions are met: (1) the lessor is a corporation whose stock is wholly owned by the private foundation; (2) the lease did not violate the limited restrictions on self-dealing in effect prior to the Tax Reform Act of 1969; (3) the terms of the lease are at least as favorable to the private foundation's wholly owned subsidiary as a lease entered into in an arm's length transaction would be; (4) the private foundation's subsidiary corporation is not itself exempt from income tax; and (5) the disqualified person (the lessee) became a disqualified person solely because of contributions made to the private foundation before October 9, 1969.

The bill would extend through December 31, 1989, a transitional rule permitting the sale of stock by a private foundation to disqualified persons even though the private foundation was not obligated to dispose of that stock.

The bill would extend through December 31, 1989, the present transitional rule permitting the continuation of leases with disqualified persons if those were in effect on October 9, 1969.

The bill would extend through December 31, 1989, the existing transitional rule permitting the sale of leased property that was subject to the transitional rule described in the preceding paragraph.

The intended beneficiaries [1] of the bill are: Public Welfare Foundation, Inc., a private foundation organized by Charles E. Marsh; the taxable, wholly owned subsidiaries of Public Welfare Foundation, Inc. (The Spartanburg Herald and Journal, Inc., The Gadsden Times, Inc., and The Tuscaloosa News, Inc.); and three newspaper operators (Newspaper Management-Production, Inc., Gadsden Times Publishing Corporation, and Tuscaloosa Newspapers, Inc.) who lease the assets owned by Public Welfare Foundation, Inc.'s wholly owned subsidiaries.

The principal owners of the three operating companies are, respectively, Phil Buchheit, Frank Halderman, Sr., and James B. Boone, Jr. The newspapers operate in South Carolina and Alabama.

Alternatives

The staff understands that there are several alternative proposals which may be presented in connection with the consideration of this bill. In general, these proposals would limit the scope of the relief provided by the bill. Under one proposal, the bill would limit the extension of the transitional leases only to 1989 and only in the circumstances described above in the discussion of the provision of S. 1514 relating to the indefinite continuation of certain leases. Under a second proposal, the definition of a "substantial contributor" would be changed so that contributions made in lieu of rental payments on certain leases made prior to 1969 would not be taken into account in deciding whether any person met the 2-percent and the $5,000 tests under section 507 for purposes of determining whether that person was a "substantial contributor."

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[1] The first provision in the bill, permitting an indefinite continuation of certain leases, appears to be drafted so as to apply only to the situation presented by the intended beneficiaries listed above. The second provision does not appear to relate to that situation. The remaining two provisions apply across-the-board, and so would affect all private foundations with "grandfather clause" leases.

Effective date

The bill would take effect upon enactment.

Revenue effect

The bill is not expected to have any effect on the revenues.