

THE ROLE OF FOUNDATIONS
TODAY AND THE EFFECT OF
THE TAX REFORM ACT OF
1969 UPON FOUNDATIONS

COMMITTEE ON FINANCE
UNITED STATES SENATE

RUSSELL B. LONG, *Chairman*

TESTIMONY PRESENTED TO THE
SUBCOMMITTEE ON FOUNDATIONS

VANCE HARTKE, *Chairman*



OCTOBER 1 AND 2, 1978

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OPENING STATEMENT OF SENATOR VANCE HARTKE, CHAIRMAN
SUBCOMMITTEE ON FOUNDATIONS

OCTOBER 1, 1973

This is the first meeting of the Subcommittee on Foundations of the Senate Finance Committee. Foundations have played an important part in American life since colonial days. Today, there are more than 31,000 foundations with grants totaling around \$2.2 billion in 1972 alone.

Traditionally, American foundations have been concerned with meeting important human needs. The early foundations set the tone for this concern by their involvement in education and social welfare. Foundations are much more than a means for the wealthy to divest themselves of surplus money painlessly. They are a means whereby those with surplus money can turn that money to uses which benefit the public.

It is because of the importance of foundations to American society that this subcommittee has been formed. The human needs which gave rise to many foundations in the past will increase, rather than diminish, in the coming years. This change will heighten the importance of foundations and lend greater importance to the need to examine their operations and look to their future. The problems of students and schools, the young and the old, the scientist and the engineer, and the poor and the hungry and the sick -- these have been the traditional concerns of foundations in the United States and they are likely, with various changes in emphasis, to be the concerns of foundations in the future. This subcommittee must examine the extent to which such private philanthropy can and should be encouraged so that important human needs can continue to be met.

The Tax Reform Act of 1969 established a whole new set of rules applicable to charitable contributions and to the operation of charitable organizations. That legislation was designed to insure that tax benefits conferred on private foundations result in a reasonably commensurate public benefit. This subcommittee will examine the effect which the 1969 Act has had on foundations. We will look into the question of whether any areas of foundation abuse remain and the extent to which the 1969 legislation was more restrictive than necessary in order to accomplish the objective of assuring that public benefits accrue from the tax benefits given to foundations.

Our session today marks the opening of a series of panel discussions and formal hearings which will explore what foundations are doing today, the effect of the 1969 Tax Reform Act on foundations, the role and the value of foundations in our society today, the regulation of foundations in the United States, the relationship between grant-making government agencies and foundations, and the future of foundations.

The participants in our session today will provide the subcommittee with a general overview of foundations in the United States today. They will also discuss the utility of foundations and whether there is a continuing need for private philanthropy. Our session tomorrow will focus on the effects of the 1969 Tax Act on foundations and the experience which other countries have had with the regulation of foundations.

Despite the importance which foundations have had throughout the history of the United States, the public knows very little of the contributions which they have made to our society. In 1969, there was public recognition of the abuses of some foundations. This recognition was translated into the restrictive provisions of the Tax Reform Act.

It is now time that Congress helped chart a path to a new understanding of foundations. I look forward to today's discussions as the beginning of a dialogue which will lead to greater public awareness of the nature of private foundations and an improved working relationship between them and the Federal government.

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TESTIMONY FOR
SENATE SUBCOMMITTEE ON FOUNDATIONS

Robert F. Goheen
October 1, 1973

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Testimony for
Senate Subcommittee on Foundations
October 1, 1973

1. Introduction

Mr. Chairman, I am Robert Coheen, Chairman of the Council on Foundations. With me is Mr. Thomas Troyer of the firm of Caplin and Drysdale, our legal counsel. We welcome this opportunity to appear before this committee to speak about the state of the grant-making foundations and the effects of the 1969 Tax Reform Act on them.

2. The Council on Foundations

The Council on Foundations which we represent is a membership association of grant-making foundations which currently has 650 members, some with large assets and some with small, located in all parts of the country. The members include 105 community foundations, 62 company foundations, and over 450 independent family and general purpose foundations. In 1973 65% or more of all estimated assets in the hands of grant-making foundations are administered by Council members.

The chief function of the Council is to advance effective and responsible performance throughout the foundation field. We do this by bulletins and newsletters on such matters as the tax regulations -- a busy line of activity, as you can imagine, the last couple of years. We conduct seminars and conferences both on a regional and national basis. We

provide consultative services to individual foundations and promote, where we can, a sharing of experience and cooperation among them. We also publish a bi-monthly journal of information and ideas, entitled Foundation News.

The Council operates under the guidance of an elected Board of Directors, whose 35 members are broadly representative of the foundation field, but also include 10 persons not directly linked to foundations. Two policy statements of our Board, recently published in Foundation News -- one stressing the importance of public reporting by foundations, the other a broader definition of principles and guidelines -- are attached to this testimony as Exhibits #1 and #2.

Another important function of the Council is to broaden public understanding of all private charitable activity as well as of the role within it of the grant-making foundations. The leadership of the Council and its members see foundations as part and parcel of the voluntarism and privately directed philanthropic endeavor which have meant so much in the development and extension of the wide and vital array of educational, cultural, and other charitable services which characterize this country. And we see the chance to appear before this Subcommittee as a particularly important responsibility for the Council in performing this interpretative and informational role.

When the 1969 Tax Reform Act was passed, some saw it as a death-knell for private grant-making foundations -- or if not that, at least as setting restrictions that would severely inhibit their ability to serve as effective charitable agents. I am happy to say that those doom-sayers

were wrong. Let me illustrate with just a few examples drawn from the past 18 months and the states represented by the members of this Subcommittee.

-- Gary, Indiana, is like many cities with large minority elements. It has been hit by a series of adverse events, including an exodus of business enterprises, draining money away when more is needed. The Cummins Engine Foundation granted funds to the city to establish an Office of Resource and Development. It is functioning to seek out Federal and other sources of assistance to give Gary the financial stability it needs to operate, to redevelop worn-out sections, and to deal with such problems as poverty, discrimination, and housing.

-- Lincoln is Nebraska's capital, the home of a fine university, a splendid place to raise a family. But as with so many other communities it has a drug problem. The Lincoln Foundation took the lead in setting up a program to combat the problem. The foundation not only acted by granting funds, but also has had an important role in co-ordinating community efforts to deal with drug abuse in Lincoln.

-- The Navajo Community College at Chinle, Arizona has become a pace-setter for the development of educational opportunities so badly lacking for reservation Indians. Among the many foundations which have contributed to the College's support are the William H. Donner Foundation, which has supplied funds to permit publication of books on the recent history of the Navajo people as part of its continuing interest

in improving education on the reservation. Through a grant directly to the Navajo Tribe the Donner Foundation has also supported the development of a reservation-wide educational agency comparable to a state department of education, to enable the Tribe to establish an effective means of contracting for and administering the numerous federal and state educational programs which operate on the reservation.

-- In Arkansas, the medical school of the state university received \$145,236 from the Inglewood Foundation in Little Rock for child study programs; Ouachita Baptist University in Arkadelphia was granted \$100,000 from the Jess Odum Foundation, also of Little Rock, for general support; and the Kresge Foundation of Michigan contributed \$100,000 to the building of a university center in John Brown University in Siloam Springs.

-- In Alaska, the Jesse Lee Home for disturbed and homeless children in Anchorage received \$10,000 from the Arthur Vining Davis Foundations of Florida, while an application by the University of Alaska brought \$400,000 from the Ford Foundation for a 3-year study of policies affecting Alaskan education.

Altogether within the 5 states during 1972 and 1973, foundation grants over \$5,000 and \$10,000 on record with The Foundation Center

totalled 376 in number and \$24,883,459.* In Indiana alone during the 18 months there were 267 such separate major foundation grants totalling over \$17,000,000, and they went to a wide array of service organizations in the state. YMCAs, the Girl Scouts, childrens' homes, local health centers, programs combatting racism, programs fostering ecumenical cooperation, planned parenthood clinics, 4-H Clubs, public TV, children with learning disorders, drug addicts, and deaf adults were among the beneficiaries -- alongside colleges, hospitals, museums, and churches.

These then are a few examples of grant-making foundations doing their job, which primarily is to assist organizations, both public and private, that serve the myriad needs of people. If this Subcommittee is to have further hearings, beyond those scheduled for today and tomorrow, I would like to urge that the testimony of a broader span of representatives of recipient organizations be sought. There is no better way to get a feel for the many sensitive and indispensable ways in which foundations are helping meet significant needs.

*The Foundation Center's Grants Index through 1972 includes only grants of \$10,000. Beginning with 1973, grants over \$5,000 are being listed. Information on grants included in the Index is obtained from press releases and annual reports furnished by foundations to the Center and does not include additional grants that would, for example, appear in IRS reporting forms. The Center plans to record information on grants shown in IRS reporting forms for foundations with assets over \$1 million in the future.

3. General dimensions of the foundation field

I have been asked to give an over-view of the foundation field in its current state.

As the Chairman and members of this Subcommittee doubtless know, philanthropic foundations are of several kinds and vary greatly in size, structure, chosen areas of activity, and modes of operation.

Under classifications established by the Tax Reform Act of 1969, as many as 37,000 foundations may exist today in this country. Of that total, according to the most recent IRS reports, slightly over 700 are private operating foundations. That is, they are primarily involved in conducting charitable activities with their own personnel or facilities, rather than through grants to other institutions or agencies.

Then there are the community foundations or trusts, numbering about 240 at latest count. They are marked by a local or regional focus, relatively broad funding from the local or regional sources, and boards of directors that are also broadly based. Some of the community foundations own substantial assets. This is the case, for example, in the oldest of them, The Cleveland Foundation. Its endowments altogether now amount to some \$166.8 million (market value). But most community foundations are far newer and remain much less richly endowed.

Finally, there are the so-called private non-operating foundations. These, too, are of several kinds and encompass great differences in purpose, scale, and method. They include, for example, somewhere between 1,200 and 1,400 company sponsored foundations established by business corporations

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to help them institute and carry out systematic programs of charitable giving. Far the most numerous of the private foundations, however, are the independent family and general purpose foundations.

According to most recent reports from the IRS, organizations classified as private, grant-making foundations number today in the neighborhood of 31,000, and possibly as many as 4,000-6,000 more will be added to that total from among organizations still awaiting definitive rulings on their tax status.

Altogether, by estimate of The Foundation Center the private, grant-making foundations hold \$28 to \$30 billion of assets at market value. But only about 2,000 foundations are worth more than \$1 million each, while about 350 hold assets worth over \$10 million. Foundations known to have assets over \$100 million (market value) numbered 46 in 1972. I cite these figures not only to outline the broad dimensions, and very considerable diversity, of the foundation field as it exists today; but also, the limited and dispersed nature of the economic power resting in foundations merits recognition.

For instance, of all the private giving in the United States -- some \$23 billion in 1972 -- foundation grants accounted for about 10%, or \$2.2 billion. That percentage surprises most people. They assume the foundations are bigger than they are. Actually, the largest contributor to charitable causes is the people -- you and I and millions of other individual Americans. Those who worry that foundations exercise excessive

financial power should compare \$2.2 billion disbursed by 31,000 or so separate entities with the over \$25 billion in annual program outlays of the Department of Health, Education and Welfare over and above Social Security payments, or with the billion dollar transactions of any number of corporate giants.

Even in aggregate, the wealth controlled by the some 31,000 grant-making foundations is, for example, very much less than one-fifth of that held in the country's pension trusts, reported as \$150 billion at book value in 1972, and several individual pension trusts considerably exceed in size the assets of the Ford Foundation -- which at \$3.2 billion are in turn 2 or 3 times greater than those of the next largest foundations, and many more times larger than the general run. In brief, an important feature of the financial resources represented in the foundations is that they are not under centralized control but are instead broadly dispersed, available to help respond to the great variety of human needs in their just as varied circumstances.

In comparisons of size such as those offered, foundations are Davids to Goliaths. But as that analogy reminds us, small assets well directed can produce important results. That is the prime significance of foundations. Foundations can be more objective, more searching, more systematic, and have a longer eye to the future than the giving of individuals tends to be. They can also be more flexible, more adaptable to specific situations and to specific institutional potentials, less bureaucratically constrained, than governmental appropriations and governmental agencies generally can be. In other words, the organized foundation, devoting time and care to the choices that confront it, is in position to make its dollars have a maximum charitable impact.

Some foundations do so by helping established institutions meet their expenses. They give money to colleges and private health-care agencies, to churches and museums, to symphony orchestras and the like. Others support experimentation. They give to new approaches in inner-city schooling, rural cooperatives helping former sharecroppers, population stabilization agencies, groups aiding mature women find careers. Many, many more foundations are variously involved in the vast range of public purpose activities that span the spectrum of American life, from day-care centers to wildlife conservation to basic research on submicroscopic viruses and the vast realms of astronomy.

Over the decade 1963 through 1972, annual foundation giving increased from about \$.82 billion to about \$2.2 billion by best available estimate. Through 1971 and 1972, according to records of The Foundation Center, the distribution of gifts overall was education 30%, welfare 16-3/4%, health 15-1/4%, science and technology 13%, international activities 11%, humanities 9%, and religion 5%. These proportions seem in keeping with the averages for the past 10 years and more, except for an upward shift of 3-4% in support for welfare agencies since the mid-1960's, and a commensurate down-swing of 2-4% in support for international activities and education. In particular, grants dealing with problems of the inner-city, minority groups, delinquency and crime have increased. Support has also grown in the health area following new concerns relating to environmental protection and drug abuse prevention.

4. The 1969 Tax Reform Act Is Working

I wish to turn now more specifically to the 1969 Act and its consequences for foundations. As indicated, a chief concern of the Council on Foundations has been to advance effective and responsible performance throughout the foundation field. Thus, as some members of this committee may remember, during the 1969 hearings the Council went firmly on record favoring federal legislation to foreclose self-dealing in the management of foundations, to insure a reasonable annual pay-out, to institute strengthened auditing of foundations funded by an audit fee, and to require a better public accounting from them.

The legislation that resulted in 1969 imposed all of these restrictions, and more, on the private foundations. Major additional requirements of the 1969 Act include: phased divestiture of substantial interests in companies, prohibition of speculative investments, new controls over grants to individuals and certain other types of grantees, stringent restrictions on the funding of voter registration drives and on activities that might influence legislation, an additional set of special limitations on deductions for gifts to most private foundations, and a 4% "excise tax" on net investment income.

These rigorous provisions of the 1969 Act have been accompanied by a marked extension and intensification of the supervision of foundation performance by the Internal Revenue Service. As evidence of this, IRS expenditures on the auditing of foundations have increased more

than eight-fold, rising from \$1.6 million in 1968 to \$12.9 million in 1972. It is now the announced intent of the IRS to have conducted audits of all foundations by the end of 1974.

Moreover, the 1969 Act has armed the IRS auditors with a range of tough, new sanctions -- including penalty taxes against both foundations and foundation managers that can aggregate well over 100% of the amounts involved in some situations -- to enforce compliance with the laws governing foundations.

Among existing foundations no one could claim that all are beyond reproach, fully efficient and fully responsible under both the law and their basic charitable mandate. Acceptance of public accountability is not the instinctive disposition of some. Moreover, the 1969 Act recognized the difficulties involved in compliance with some of its new requirements by providing transition periods. Consequently some of the reforms that Congress enacted in 1969 remain to be fully implemented. Nonetheless, as the Act's substantive provisions come into full effect, these situations will be corrected. IRS supervision with attendant sanctions should insure that. Under the mass and complexity of the new regulations a number of private foundations have decided to terminate, and the creation of new foundations appears distinctly to have been slowed. But, in all parts of the country we observe foundation managers and trustees taking their responsibilities very seriously indeed, doing all that they can to meet the requirements and complexities of the new law.

5. Problems raised by the 1969 Act

The 1969 Act on the whole, then, seems to us to have brought necessary and beneficial regulation to the foundation field. There are, however, several features of the Act which are troublesome, particularly in their impact on the actual or potential beneficiaries of foundations -- that is to say the colleges, research institutions, libraries, arts organizations, welfare agencies, needy students, and many other persons and agencies that draw on foundation help. These elements of the 1969 Act, therefore, merit, we believe, further consideration by the Congress.

(a) First, there is the 4% excise tax on the net investment income of foundations. The excess revenue raised by this tax beyond the amounts needed for proper auditing and supervision of foundations represents a serious loss to the activities supported by foundations. For 1972, IRS reports that the tax collected was \$56 million and the costs of auditing private foundations were \$12.9 million. In other words, after the costs of auditing and supervision were met, over \$40 million that would have been available to various operating charities was denied to them by the 4% tax.

In 1969 the Senate voted for an audit fee tax of one-tenth of 1% of a foundation's assets. Not only was that rate equivalent to roughly half of the 4% investment tax subsequently arrived at by the Conference Committee

and enacted into law, but the Senate version also tied the rate to the costs of administering the new law. We urge now that the rate be set again at a level closer to the actual auditing and supervisory costs, that it be earmarked for that purpose, and that the tax be redesignated as a fee for auditing and supervision. I shall return to this matter a little later in some comments on the proposal for the establishment of a new Assistant Commissioner for Employee Plans and Exempt Organizations contained in the pension reform measure just passed by the Senate.

(b) Secondly, Congress should be aware that the mass and intricacy of the regulations implementing the 1969 Act are very great. The complex provisions relating to restrictions on program are especially troublesome. While the final regulations for this area were issued only in December 1972, we have already seen real concern on the part of many of our members with their potentially stifling effect on giving programs. Much time of staff, attorneys and accountants must now be spent on determining the precise tax category of the grantee, on assessing the effect of a grant on that category, and on obtaining formal reports required from certain grantees. It is too soon, however, to urge specific answers to these difficulties. The experience of another year or so of audits and reporting should be helpful. The new IRS form for private foundations, 990-PF, should be helpful in these regards.

(c) Thirdly, there are two broad aspects of the Act which in conjunction raise troubling prospects as to the future capability of foundations to continue as significant sources of assistance to the country's various educational, cultural, medical and other charitable service activities which foundations have helped to stimulate and support.

On the one hand, these activities are almost all highly labor-intensive and the opportunities for increased productivity in them are small and come slowly. Hence cost-rises in excess of the general increase of the cost-price index are part and parcel of these activities. Their particular inflation (which must be figured to run 3% or so per year in excess of the general increase of the costs of producing goods in the U.S. economy¹) coupled to the high pay-out requirement (in the range of 6% of foundation assets by 1975) means in all probability a progressive decline in the real support power of the existing foundation dollar. This is so because even very well-managed portfolios are not likely to earn a total return of more than 9% a year on the average.²

1. A recent study by Joseph Goldberg and Wallace Oates, The Costs of Foundation-Supported Activities (1973), copies of which we shall be glad to supply to the Subcommittee, shows this to have been so consistently over the past 20 years. The chart attached as Exhibit #3 illustrates this phenomenon.

2. For example, the National Association of College and University Business Officers and Professor J. Peter Williamson at the Tuck School at Dartmouth have been keeping records on about 150 institutional endowments and some 158 mutual funds. Of 95 endowments, only 7 (i.e., 8%) were able to produce a total average return of 9% or better for the 5 years ending June 30, 1972. If one adds in the 158 mutual funds, making a new grouping of 253 funds, the number that achieved a 9% return was only 25 (=10%).

Join to this erosion of the support power of existing foundation assets the several requirements of the Tax Reform Act which discourage the establishment of new foundations and the augmentation of old ones: e.g., the 4% tax, the "less-favored" treatment of gifts of appreciated securities to foundations, the added administrative and legal costs occasioned by the complexities of the Tax Reform Act. The composite effect is a steady diminishment over time of the capacity of foundations to support the sorts of activities and organizations they now assist.

Because we believe firmly that foundations have made important contributions to the educational, cultural, medical, and other charitable services available to our people -- and because we are convinced that comparable contributions remain important for the future -- we are much concerned about these apparent long-term consequences of the Tax Reform Act as it is presently constituted. We therefore hope that these two matters of the required annual pay-out rate and of reduced incentives can be re-examined by the Congress in order to secure both a reasonable annual current return to charity and due regard for the needs that lie ahead.

The actual and potential significance of the privately supported, grant-making foundations in the private service sector of America, let me emphasize, lies not simply in the funds that they make available to operating charities, such as universities, hospitals, welfare agencies and the like; they are themselves also examples of the pluralism which is one of the great strengths of our society, for they serve as points

where independent scrutiny, sympathetic concern, imaginative initiative, and purposeful planning are often fed into the total effort.

Moreover, churches are not eligible for Government support, while agencies for the character-building of youth and many other bona fide charitable purposes must derive most of their support from private sources. Even when Government money may be available, it is vital that it not be in monopolistic control. According to a December 1972 survey conducted for the Council by the Gallup organization, 70% of the people hold that view. They believe private philanthropy to be as important today as ever in the past, and think that foundations should be active in attacking many of the same social concerns that also properly engage governmental agencies. Foundations can often respond quickly and flexibly to emergency needs. They can fund studies and trial programs on which Government programs may later be based. Even when foundations make mistakes, they are on a relatively small scale, and if they help Government not to legislate bigger ones, their very capacity to err is a benefit.

For all these reasons, it seems to us of very considerable moment whether the tax laws are going to permit and encourage foundations in the future to play at least as telling a role as the best of them now do within the context of American philanthropic enterprise. The argument here is not that every foundation should exist forever -- but I would insist that foundations which show a capacity for self-renewal and for sensitive and responsible service over time surely thereby have a claim to continued existence at least as great as that of any other charitable

institution. Our main concern is that foundations as a whole not be consigned to a diminishing role in our country's future. The need for the contributions which the grant-making foundations now make to the general welfare is not going to shrink unless there are to be radical changes in the structuring of our society. Instead, the needs will grow. Consequently the flow of new resources into the foundation field should be encouraged rather than discouraged.

6. Related Concerns

Before offering a concluding statement there are three related concerns to which I wish to call the committee's attention briefly.

One is the great difficulty we all now face when we seek accurate, systematic data about the current extent of American philanthropy and its many components. There is really only one source that could be definitive, if it were so organized, and that is the Treasury Department using the records of the Internal Revenue Service.

Because of the heightened interest which has been generated in recent years about private philanthropy in relation to tax receipts and tax law, it would be both timely and most useful if the Internal Revenue Service's procedures for collecting and reporting information on charitable giving were brought more nearly up to date and made to include more distinctions as to scales of donation and types of recipients. (Currently the only available summary of this sort is Giving USA published by the American Association of Fund-Raising Counsel, Inc. and we are fortunate to have it. But as its editors regularly say, it represents

broad estimates as much as it does firmly verifiable facts.) I would like to suggest that Congress urge on the Treasury the importance of a more current and useful record of philanthropic giving.

Secondly, even in the absence of all the evidence one would like, it is very evident that the charitable deductions provided by estate and gift taxes have performed important functions in encouraging substantial donations to the country's charitable organizations, both public and private. Today these deductions constitute an highly important, continuing set of encouragements for those fresh additions to the foundation field which I have already argued to be in the public interest.

Historically, according to a 1969 study, 54% of the assets of foundations in the \$1-10 million size and 46% of the assets of those in the \$10-100 million size derived from bequests as of 1968.* 81% of the capital of community foundations had a similar origin. Available data are too fragmentary to permit an updating of these figures. But with inter vivos contributions to foundations clearly down, estates take on heightened importance for the foundation field as the one remaining area in which tax incentives are conducive to its replenishment and growth. In various quarters proposals are afoot to limit the proportion of estates that may be left to charity free of tax. For the reasons indicated, it seems to us that the incentives to charitable giving through bequests should not be curtailed, and we would hope the members of this Subcommittee will help to uphold the existing incentives.

*Foundations, Private Giving and Public Policy (Chicago, 1970), pp. 247-248

Thirdly, let me comment on the proposal for a new Assistant Commissioner for Employee Plans and Exempt Organizations. Ideally, I believe, the supervision of charitable activities would best be conducted by an independent agency established for that purpose, as is the case, for example, in Great Britain where the Charities Commission performs that function. One of the panels scheduled for tomorrow will, I understand, be testifying to the Subcommittee on that sort of approach.

Short of a solution that far reaching, the proposal in the new Pension Bill appears to us to have much to commend it. As the report of your parent committee points out, the proposed realignment in IRS should make it easier for the Service to respect and further the basic objectives of charitable organizations while insuring also the effective regulation of foundations in accordance with the 1969 Tax Reform Act. One feature of the new proposal that we particularly favor is the earmarking of a portion of the 4% investment tax on foundations for the costs of auditing and supervision. As previously indicated we would further urge, however, that that tax be redesignated as an auditing fee and that its rate be set at a level consonant with the actual costs.

7. Summation

In concluding, I wish to suggest to this Subcommittee, as I have earlier to the House Ways and Means Committee, that the time has come for a new approach to foundations by the Congress. In 1969, the American people and their elected representatives in Washington were deeply disturbed by evidence that certain foundations had been misused for personal gain and by disclosures of bad judgment, even, perhaps, irresponsible behavior, on the part of other foundations. Although the instances of this abuse

and misfeasance were in fact limited, they were sufficient to place the entire foundation field under a cloud.

Clearly it was necessary for the Congress to act, both to protect the public interest and to protect the reputation of the many good foundations. Although as I have testified, I believe some of the controls contained in the Act are overly restrictive of bona fide foundation activity and therefore not in the public's best interest, the task of so regulating foundations that they must necessarily serve the general good of the nation has been accomplished, and on the whole accomplished well. For this reason, we submit, a new climate of opinion is now merited, one which recognizes the capacity of foundations to help meet important human needs. Congress, the Council believes, can properly -- and should -- take a hand in establishing such a new climate of opinion. It is time for Congress to show that it considers foundations a national asset and that it wishes to give encouragement to their activities.

Never, indeed, have foundations been more needed than today. With many grievous social problems calling for new, experimental approaches at solution, with severe cutbacks in the availability of Federal funds, with private sector educational, medical and social welfare institutions in deep financial trouble, the initiative and resources foundations can provide are desperately required. No longer should they be regarded as

marginal institutions operating in a twilight zone of official disapprobation. It must be made clear to them that they enjoy the confidence of the nation's highest legislative body and that superior performance is needed and expected of them. For their part, foundations, we believe, will respond to such a new approach and will give their best.

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A Policy On Public Information

The Council on Foundations has undertaken a "national awareness program" that is designed to inform the public of the positive contributions of foundations to society, and to emphasize to foundations those policies and procedures that can improve performance.

The Policy on Public Information published herewith is the first of a series of statements on issues of importance to the foundation field, which the directors of the council intend to develop and issue as part of the national awareness program.

It is the policy of the Council on Foundations to encourage foundations to communicate to the public facts about their activities. To this end, the council has sought both to assist foundations in the development and carrying out of individual public information programs and itself to gain public attention and understanding for the work of grant-making foundations. Although it represents no new policy, the council seeks to reaffirm with this statement the desirability of an active information program as part of the normal operations of a grant-making foundation.

There are a number of reasons why foundations should seek to be open and informative.

Foundations exist to facilitate the application of private resources and private

initiatives to the public good, and it is this capacity for public benefit which justifies their tax exemption. This is the case regardless of a foundation's character—whether it be large or small, an independent, corporate or community foundation. In this sense, foundations are public trusts and it is incumbent on them to provide a public accounting periodically and when events of special moment occur. Federal law and the regulations of some states today require an annual accounting from each foundation. Those requirements are rudimentary. The normal discharge of responsibility by organized grant-making philanthropy should include full and frequent reporting over and above the requirements of the law.

Beyond this is the benefit that may accrue to philanthropic endeavors

through open and shared information. Money from foundations, in hundreds of millions of dollars each year, supports a great variety of educational, cultural, medical and other charitable projects. In many cases the benefits from these undertakings would be extended if they were better known. More coordinated efforts might be engendered, wasteful duplication might be avoided, additional support might be attracted and potential recipients would be aided if information about each foundation's activities were available.

To be sure, needs to be met usually outrun available sources and publication of a foundation's objectives and activities may, therefore, seem to be only inviting increased administrative burdens. But, in fact, the time-consuming task of screening grant applications can often be lightened by regular reporting, for it can discourage inappropriate requests no less than encourage appropriate ones. Moreover, when foundations make known their interests they increase the likelihood that they will gain useful assistance and advice from other parties concerned with the same problems.

Foundations engage in activities which reach deeply and constructively into American life. In a vast, complex and fast-moving society these activities may be misunderstood if not presented clearly or put into perspective. This requires information to be put forward accurately to the public via the communications media.

The reticence of many foundations about publicity is often anchored in modesty and/or self-protectiveness. Nowadays, such denials of the public interest are more likely to be self-defeating than beneficial. The endeavor and accomplishments of grantees often merit the greater attention, but foundations should

not therefore spurn recognition for timely assistance given or jobs well-done. This is not to suggest a publicity program designed to stimulate plaudits; that would be as wrong as false modesty. Getting factual information to the public is the objective.

Today in America there is a general disposition to scrutinize, question and test all institutions. The conviction that foundations perform functions vital to the well-being of our pluralistic society is not universally shared. In the face of the doubts, foundations—like universities and churches, corporations and labor unions—must be prepared to demonstrate their worth in the effectiveness of their activities and by making these activities better known. They must be prepared to exhibit their wares in the marketplace of ideas to gain and hold public understanding, the good will of the people, the support of elected representatives.

For all these reasons, the Council on Foundations urges on all foundations the value of a public information program. Even the smallest of foundations can plan and carry forward a realistic program, one appropriate to its size, in discharging its responsibilities to the public, to the foundation movement and to itself.*

Robert F. Goheen
Chairman

* The council plans to issue a manual to help foundations implement such programs.

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Some General Principles And Guidelines For Grant-Making Foundations

A Policy Statement Of The Directors Of The Council On Foundations

JANUARY 1973

Preamble: We have often been asked how the directors of the Council on Foundations view the foundation field and what the Council stands for. This policy statement endeavors to answer those questions, at least partially, and we hope it may be useful both to persons responsible for foundations and others concerned about them.

1. Basic Rationale. The grant-making foundation as an institution is a means whereby nongovernmental initiatives and resources can be committed to the service of the public welfare over time. The foundation is thus an element in the creative pluralism of America and is in partnership with all those engaged in the alleviation of the many human needs felt within our society and the world at large.

Foundations have, of course, no magic keys. But overall, in the many diverse efforts they support to heal and uplift the human condition, and where possible to get to the roots of its persistent ills, the contributions of the foundations to human welfare are enormous. When at their proper tasks, they reflect the

humaneness of America at its best, as expressions and instruments of the outgoing concern for one's fellow man which is so deep in our heritage and is still so much a part of the nation's best hope.

2. Diversity. Grant-making foundations differ greatly in origin, size, purpose, organization and mode of operation. In this diversity they correspond to the multiplicity of society's bona fide charitable needs, and because of it, satisfactory generalizations about foundations are difficult. Within their general philanthropic mandate, it is fitting that some foundations should be concerned particularly with the search for fresh solutions and innovative lines of development

while others center more on the support and strengthening of existing institutions of proven worth; that some should favor progressive social causes and others more conservative ones; that some should focus on local or regional needs while others seek to extend their scope of effective concern to human welfare the world around. In these respects no orthodoxy can properly be prescribed for foundations though partisans of various limited interests keep trying to do so. The one common requirement is an essential public spiritedness. While perhaps an awkward referent in a cynical age, a commitment to the service of others must nevertheless be the basic guiding principle for all who direct or manage foundations.

3. Governmental Supervision and the Tax Reform Act. The capacity of foundations to contribute to the public welfare under nongovernmental management is the basic justification of the privileges granted to them by both the Federal government and the states—the most important of which is the tax exemption they enjoy. For the same reason, foundation trustees are allowed broad latitude as to how they perceive the public good and what elements of it they wish especially to address themselves to.

Abuse of this privilege in some cases for personal or partisan purposes has come to reflect adversely on the reputation of foundations generally, and in 1969 it led to numerous restrictions be-

ing put on them in the Tax Reform Act of that year. The act effectively rules out financial self-dealing by foundation trustees and officers, requires a greater openness and public accounting from foundations and properly insists on a substantial current pay-out to charities from foundation assets. It also contains negative features—particularly a 4 per cent excise tax on net investment income, damaging especially to recipients of foundation support; a series of provisions discouraging the formation of new foundations and the enlargement of existing ones; a setting of the pay-out requirement at levels where it may mean progressive diminution, over time, of the ability of private foundations to finance the kinds of philanthropic activities they now support; an immense amount of highly technical regulatory detail that makes the management of small foundations particularly difficult.

Despite the "overkill" contained in these provisions—which one must hope will prove open to Congressional adjustment as working experience with the effects of the Tax Reform Act become clearer—the act's forceful reminders that foundations exist for the public benefit and must be so directed have to be recognized as necessary and for the good. The same applies to state regulations affecting foundations where these have been instituted.

4. Management. Once a foundation is established and given tax exemption, neither the donors nor trustees nor staff own it. All such parties may and should

have critically important roles to play in how a foundation defines its interests, selects its targets and conducts its activities. The essential requirement is that both trustees and employees recognize their involvement in and responsibility for a public trust in relation to which self-aggrandisement and self-dealing can have no proper place.

The degree to which foundation boards or staffs should be diversified in membership to insure independent views and broad representation of the public presents difficult questions. The differences in size and scope among foundations exclude pat answers. Many foundations are being guided with marked sensitivity and concern by a donor assisted only by several friends or associates serving as fellow trustees. Yet, generally, diversified boards and staffs will tend to insure the sensitivity of foundations to the needs of segments of the society who have too often been denied adequate voice and representation. Persons from minority groups and women, moreover, often have important perceptions to bring to bear on foundation activities. Their inclusion in positions of influence within the foundation field is highly desirable.

Whether a professional staff is required by a foundation depends on the nature of the foundation, its program, and the time and attention which trustees can bring to the work. The most important thing is the quality of the work—including its sensitivity and its realism—not whether it is done by trustees, professional staff or consultants.

5. Evaluation and Program Review. No foundation, however large or small, should be complacent about the wisdom and efficacy of its giving program. Each should be constantly concerned to see how it can improve its performance and make limited resources meet as effectively as possible needs that generally far outstrip available funding. Periodic, systematic review and evaluation of program can lead to improved performance by the small, trustee-managed foundation as well as the foundation which employs staff and disburses substantial funds. The use of outside consultants or review panels will often add to the validity and usefulness of the evaluation.

6. Disclosure. Out of the public trust vested in foundations grows the need to accept the principle of full disclosure and readiness to share with concerned persons, as well as with public officials, information about objectives and activities. Too often foundations have proved inaccessible and their decision-making processes cloaked in secrecy. Federal and in some cases state legislation now require at least minimal disclosure, but positive steps taken voluntarily to minimize secretiveness can better show the concern of the foundations to serve the public with sensitivity and good faith.

A concern for informing the public of what its objectives and activities are—even when very modest—can also often help a foundation's managers gain useful advice and criticism relating to areas of particular interest to them. It also can

forestall inappropriate applicants and the irritation of exaggerated expectations let down.

7. Cooperation. More cooperative activity among foundations can be beneficial both to them and to potential recipients of foundation support. Small foundations can often increase their effectiveness by pooling resources to employ expert advice or to hire a staff which none of them could afford alone. Community foundations and the larger private foundations can often assist smaller foundations by sharing information and experience.

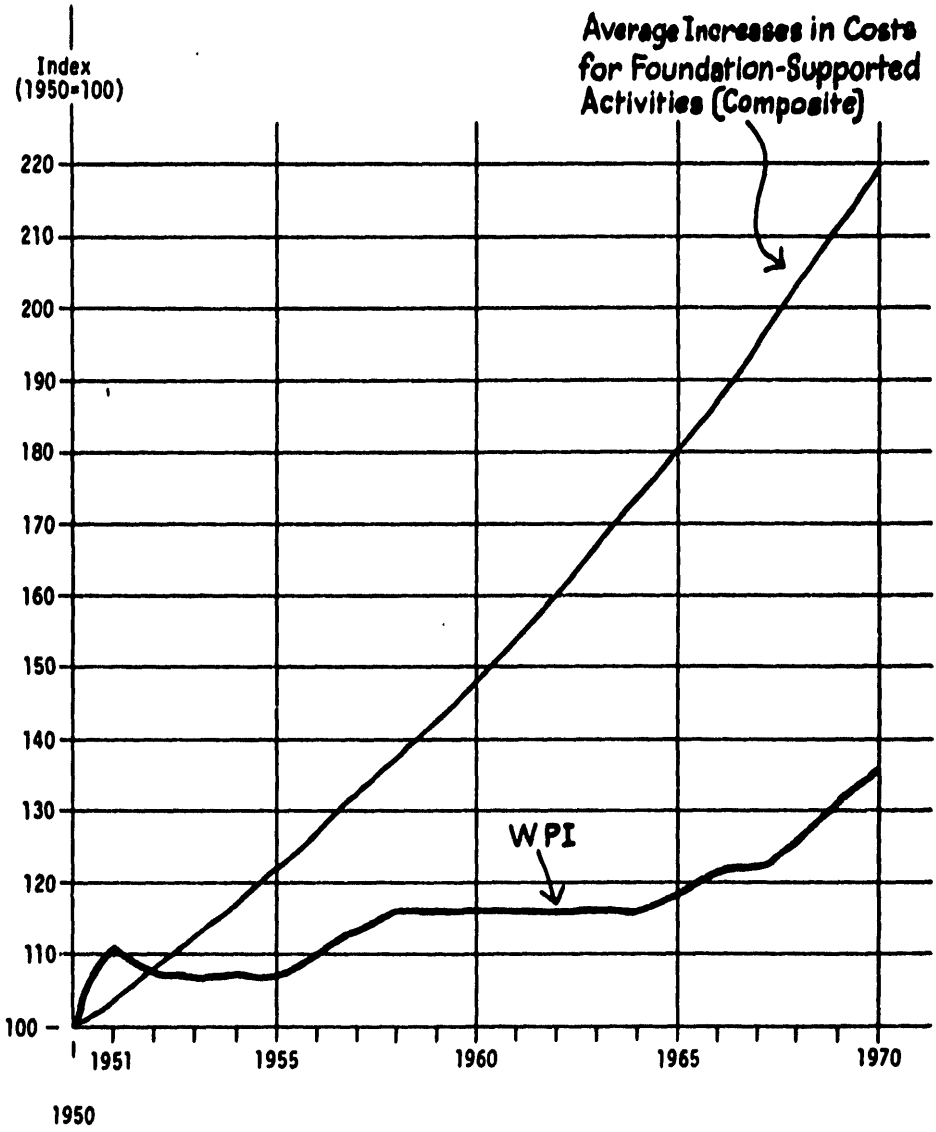
It is the policy of the Council on Foundations to encourage and extend such cooperative possibilities within the foundation field. At the same time the Council seeks to serve as a center for useful information and guidance for grant-making foundations of all shapes and sizes.

8. Operating Relations with Government. The law rules out partisan political activities and, with limited exceptions provided by Congress in 1969, action to influence legislation. Foundations are not barred from sponsoring the study and discussion of public issues even when such issues are taken up by Congress and other legislative bodies. And foundations are fully entitled to inform members of the Congress, as well as other agencies of government and the general public, of their activities.

Moreover, foundations are entitled under the law to interact with executive agencies at Federal, state and local levels. Not only may they work in partnership with government agencies, they can promote objective evaluation and monitoring of government programs, and can fund competitive programs in fields of interest to both government agencies and private philanthropy.

EXHIBIT 3

Indices for a smooth 4% trend-line
representing costs of foundation-supported activities
and the Wholesale Price Index



Summary of Statement by
Landrum R. Bolling, Executive Vice President of Lilly Endowment
Submitted to Subcommittee on Foundations of Senate Finance Committee

1. Many earlier issues in debate over foundations now settled, thanks to Tax Reform Act of 1969. Central question relates to whether foundations should exist at all and whether they truly serve public needs.
2. Case for foundations similar to case for private philanthropy in general: a) to encourage voluntarism and personal responsibility; b) to promote decentralization of some public services; c) to provide alternatives to governmental methods of financing and operating certain services. Need for comprehensive public policy to encourage private philanthropy. Endorsement of idea of direct tax credit incentive for lower-income taxpayers to give for charitable purposes (perhaps up to \$100) to eliminate present inequity in "cost" to individual donors of their gifts. This broadening of incentives for all charitable giving far better policy than attack on gift deductions as "tax loopholes".
3. Foundation policies and priorities shifting - but vary considerably. Generally, lessened interest in science and technology due to massive expenditures by government in these fields. Growing concern for urban problems and small-town economic development. Shift away from interest in educational buildings, teacher salaries and graduate training. Growing interest in pre-professional preparation and values education.
4. Public input in foundation work through broadening of boards and professional staffs, use of consultants, and "open-door" style of administration.
5. Ultimate influence of a philosophy of trusteeship on which foundations should be operated.

STATEMENT BY LANDRUM R. BOLLING
EXECUTIVE VICE PRESIDENT OF LILLY ENDOWMENT, INC., INDIANAPOLIS, INDIANA
SUBMITTED TO SUBCOMMITTEE ON FOUNDATIONS OF SENATE FINANCE COMMITTEE
October 1, 1973

It is inevitable, and desirable, that foundations should be called upon, from time to time, to account for their performance, to document their service to mankind, to justify their existence within our pluralistic society. All of us invited to testify before this Senate Subcommittee on Foundations, I am sure, welcome the opportunity to report on the activities of foundations as we know them and to try to answer any questions that might be raised about them.

Let it be quickly said that the foundations, as institutions dedicated to the use of private funds for the support of public educational, religious, scientific, charitable and cultural purposes, simply could not exist in a totalitarian dictatorship of the Right or in a totalitarian dictatorship of the Left. Nor could they be created and sustained in a society devoid of individual impulses to generosity and public service. Nor will they long survive if our governmental policies come to be shaped by the judgment that governmental agencies, spending tax monies, could and should provide all the charitable, educational and cultural services hitherto supplied or supported by private philanthropy.

At the heart of the debate over foundations--a debate that has already lasted for several years--is an argument over this basic question: Should a private, nonprofit corporate organization be allowed to hold and manage substantial funds given to it by private donors and decide on their use in the public interest or should all such funds be taken over by governmental agencies for disposition through political/governmental processes? Some of the earlier issues over foundations are now settled--thanks to the Tax Reform Act of 1969--and should have been settled long ago. Foundations can and must make public reports on their operations. They can and must meet some minimal annual pay-out requirement, though the exact percentage is still debatable. They should and must avoid self-dealing with trustees or staff members or their relatives. They should and must refrain from efforts to influence the outcome of political campaigns. They cannot and must not be used to enable certain individuals to escape their just and lawful tax obligations. All of these are, in essence, issues that have been settled. No one with any sense of social responsibility can defend the abuses by a few foundations that those prohibitions were designed to correct.

Today the debate over foundations seems to come down to these questions: Should foundations be allowed to exist at all? Should punitive restrictions on legitimate foundations be removed? Should new foundations be encouraged? If the answer to all these questions is Yes--and I believe it should be--then the public policy implications of such an answer are fairly clear. If the answer is No, then we have to call into question the whole justification for private initiative and private generosity in the service of public needs.

The case for foundations rests ultimately on the case for private philanthropy in general. That case, I suggest, is based upon these concepts:

One, the importance of encouraging voluntarism in the satisfying of social needs, of maintaining the human, empathetic feeling of personal responsibility in the face of social needs.

Two, the wisdom of decentralization, down to the local grass roots, of some portion of the tasks of providing our educational, cultural, charitable services.

Three, the usefulness of having available some alternatives to many government services, even where those government services may be universally accepted as the norm.

There are many other ways of stating the justification for private philanthropy--the oldest being the ancient teachings of all the great religions of the world about the obligation of man--in fulfillment of his obligation to God--to give of his resources and his time to aid the widows, the orphans, the sick, the poor, the oppressed. But even to secular minds in a secular age it is clear that we become a poorer, less humane, less responsible, less efficient, more bureaucratic and more callously indifferent society if we stifle private initiative and responsibility for philanthropic giving in favor of a government monopoly in the handling of all social needs. It is obviously not a case of either-or; it is a case of both together. We have to have government programs for social and cultural services, but we also need private philanthropy, including the foundations.

All of this being true, we need a comprehensive, coherent and consistent public policy to encourage private philanthropy. With all the

proper safeguards to prevent selfish abuses, we still need incentives to encourage individuals and organizations to act upon their charitable impulses. That these impulses may be tinged at times by less than totally altruistic motives is no argument against the wisdom of providing incentives to giving.

Speaking entirely as a private citizen, not in any way as a spokesman for Lilly Endowment or foundations in general, I want to express strong personal endorsement of the concept that the incentives to private giving should be broadened and strengthened so that the lower-income individual might have inducements for giving comparable to the inducements afforded to higher-income givers. Specifically, I would urge the Congress to offer to all taxpayers the right to make contributions of up to perhaps \$100 each to any legitimate IRS-approved educational, religious or charitable organization on a full, direct tax credit basis. It is sometimes pointed out that it is possible for a high-bracket taxpayer to give a \$100 contribution to his charity at a net cost to him of \$30, under current deduction schedules, but that a low-income taxpayer who wants to give that same amount of \$100 to perhaps the same charity does so at a net cost to him of \$70. This arrangement it is argued is not fair or equitable. It isn't. But the answer is not to denounce all gift incentives as "tax loopholes" (an over-worked and often misleading swearword in much of the debate). The answer is to design an equitable system for encouraging the broadest possible base for philanthropy with suitable incentives for both high-income and low-income taxpayers, not to hamper giving from the larger pools of wealth.

Foundations should and can function--and those I know do function today--within the bounds of propriety and social responsibility. As part of

the total complex of private philanthropy they not only make possible useful public services that in most cases would otherwise, in one way or another and often at much greater expense, have to be provided by tax monies; they also help to maintain the very pluralism and freedom of American society. Rather than being regarded, as they are by some critics, as privileged and selfish enterprises to be tolerated only so long as may be politically expedient and then laid to rest, foundations should be seen as playing a permanent and vital role in serving essential human needs and in encouraging voluntary initiative and private responsibility. Those now in existence should, under appropriate regulation, be encouraged to continue. And, under appropriate controls, new foundations should be helped into being.

In the long run, of course, private giving can be justified only if it provides real social benefits. Foundations have to be judged by what their giving has accomplished, by how well they allocate their money to serve the needs they are supposed to serve. They are today being increasingly monitored--by I.R.S., by the media, and by the Congress. Increasingly, and rightly, they are doing a more extensive job of monitoring the projects they support.

Foundations vary enormously in their fields of interest and programs, as well as in the size of their resources. They, moreover, do not remain the same. For most of them what they did yesterday is not necessarily what they are doing today or what they will be doing tomorrow. They, like other social institutions, try to respond to the current needs of society--a society characterized by constant change and changing social needs.

Today, quite clearly, a number of the larger foundations give high priority attention to urgent issues related to our decaying cities, to

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problems of drug abuse, juvenile delinquency, poverty, family disintegration. At Lilly Endowment we, too, have provided support for a number of urban projects--minority business development projects in Indianapolis, street academies for young drop-outs in New York, child care training programs in Chicago, and addiction services and youth recreation programs in a number of cities. But, at the same time, we have also felt we should give deliberate attention to the economic and social needs of small towns and rural areas. In considerable measure, the problems of our great cities today are compounded by the excessive flight of poor people from the farming communities and the small towns where many of the problems might have been more humanely solved. It is our conviction at Lilly Endowment that we can and should attempt to do more to help improve economic opportunity and advance the quality of life in the often neglected open country regions of America. To that end we support self-help economic, educational and cultural projects in small communities in Alabama, Kentucky, Tennessee, North Carolina, Indiana and Arkansas. We have contributed to Indian reservation projects in Arizona and the Dakotas. We are actively exploring the possibilities of investing more of our resources in matching programs in which people in the forgotten smaller towns and rural areas are attempting to help themselves. It is not a question of either-or; again, it is a matter of both together. We need to work with local organizations for human advancement in both the big cities and the small towns.

The roles of private foundations in the fields of scientific research and medical facilities and services have obviously changed drastically in the last several years. The enormous investments of recent years by the Federal Government in research through the Department of Defense, the National Science Foundation, the various National Institutes of Health,

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and other government agencies have changed the whole situation so far as foundation programs in science are concerned. The billions of tax dollars for these purposes have tended to persuade private foundations to allocate their funds to other fields. Yet, in spite of that general tendency, the Robert Wood Johnson Foundation, one of the largest in the country, has committed itself to devote most of its grant money to various efforts to improve the health delivery systems across the country. Moreover, during the postwar years of great expansion of government expenditures for research and technological development, it was the Rockefeller and Ford Foundations that stimulated and largely underwrote the extensive research and testing programs that gave the world the new super-strains of food grains that sparked the so-called Green Revolution and brought such enormous benefit to vast areas and vast populations in the so-called developing nations. We have all become aware of a critical food problem around the world. Think what it might have been had it not been for those Rockefeller and Ford Foundation grants!

Sometimes a foundation may play a useful role in applying the science and technology already available. Today in another place in this city the privately supported philanthropic organization AFRICARE is holding a press conference to tell of the drought and famine conditions in the parched areas of several of the Sub-Sahara countries of West Africa--and to report on a recent small success in which an American foundation was involved. The several million people whose very survival is threatened by this natural disaster can probably be enabled in time to win their age-old struggle with the elements through much more extensive boring of wells and building of large and small reservoirs and applying more generally both ancient and modern methods of irrigation. For this considerable planning

and financing--chiefly from governmental sources, including the U.S.--must be provided. Meanwhile, what happens to crops that once more are about to fail?

Based on the use of photographs taken by America's orbiting astronauts and on-site studies by U.S. meteorologists, it was decided that during the month of September it would be possible to produce in the Republic of Niger significant quantities of rain by artificial cloud seeding techniques. But how to get such a risky project undertaken on such impossibly short notice? The President of Niger, having failed to get help through the normal international and national governmental channels, appealed to AFRICARE, a public U.S. charity concerned with African projects. AFRICARE in turn presented a grant request to Lilly Endowment. We were fortunately able to get a U.S. citizen consultant to make a quick independent check on the project through a visit to the area and to secure reports and recommendations from technical experts. Our Executive Committee, accordingly, authorized a grant of \$50,000. This made it possible for two experienced American pilots to ferry two small planes and the necessary equipment across the South Atlantic to West Africa and to start the cloud-seeding operation promptly. All of this was done within about two weeks after the meteorological survey had been completed. Fortunately, the gamble paid off. Rain was produced. Some benefit to this year's crop was provided. Other countries in West Africa are now officially studying this approach to a partial solution to their drought problems.

This, as I must point out, can only be called a "small success." It is certainly not an answer to the long-term famine threat to West Africa. And it could have been a total failure. Yet we had, as a private foundation, the flexibility to act quickly and the freedom to take a chance.

That kind of flexibility, that kind of risk-taking freedom is one of the significant justifications for foundations--and always will be.

Education is and will remain a major concern of the foundations. Here, too, priorities are shifting. After World War II these were among the high-priority concerns of educational institutions and of both the government and the foundations:

1. the rapid expansion of physical facilities to take care of what were thought to be ever-bulging enrollments;
2. the raising of wretchedly low faculty salaries;
3. the expansion of graduate training in order to turn out more teachers and more scientists.

With all three objectives America has succeeded--almost too well. The American educational community and the foundations, of necessity, are now turning to other priorities, though obviously, as always, there are differences of opinion and differences of interest concerning the new priorities.

I speak only for Lilly Endowment when I say that now among our high priorities in education are the following objectives:

1. We are concerned to encourage the private colleges and universities to do a better job of fund raising from their own natural constituencies and to improve their internal management. We are providing a variety of challenge grants to this end.
2. We want to support efforts directed at greater co-operation and joint planning between the public and private sectors in higher education. As a society we

cannot afford endless duplication of educational facilities and programs, particularly in a time of slowing growth in college enrollments.

3. We are interested in certain modifications and improvements in undergraduate education that look toward more explicit pre-professional training and for relating the academic community more closely to the "outer world." In that connection Lilly Endowment has just funded the Woodrow Wilson Foundation in launching a program of senior visiting adjunct professors drawn from business, diplomacy, journalism and other professions to participate in the educational programs on a number of smaller and more isolated college campuses across the nation. We are delighted that your long-time colleague Senator Margaret Chase Smith has agreed to be one of the first of these visiting adjunct professors.
4. At all levels of education we are interested in encouraging a variety of efforts to improve education for personal value development--to use an old-fashioned term, for character development. This is perhaps the hardest, most elusive task in education, but we feel that in time of great stress and confusion over moral, ethical and social values, these issues have to be confronted and we are encouraged to discover that a considerable number of educators and parents share

these concerns, as did Socrates, Jesus and other great teachers a long time ago, and are working at both teaching and research projects in this area.

One question inevitably raised about foundations has to do with the extent to which these organizations meet the needs that are represented in the appeals made to them and in the grants dispersed. The answer is that inevitably only a very small fraction of the needs presented to foundations are ever met by the grants made, simply because most grant requests have to be turned down. It is a kind of rule-of-thumb that in dollar terms foundations can attempt to satisfy only something less than ten percent of the requests they receive, and my impression is that the correct figure may be even less than five percent. Foundations just don't have and never will have enough money to take care of more than a small percentage of the legitimate and worthy requests brought to them.

In the end, foundations have to be judged not in terms of the percentage of grant requests they approve but on the effectiveness and significance of the grants made. They in turn have to exercise increasing care in evaluating the uses to which their grants are being put. Unquestionably one of the positive results of the Tax Reform Act of 1969, and the expanded public scrutiny of foundations, has been to make most foundations give more explicit attention than previously had been the case in evaluating the results of the projects they have funded. This means, inevitably, higher administrative costs, but the results should improve the performance of both the grant-making foundations and the grant recipients.

Other witnesses have been asked to present testimony on the various effects of the Tax Reform Act of 1969, and that is not my assignment. However, I should like to submit as an annex to this statement some details as

to our experiences and reactions to the operation of that Act.

One of the questions to which I have been asked to speak is the question of whether and how the foundations are involving the public in the grant-making processes. My answer must necessarily deal with several types of public involvement.

Traditionally, most family foundations--and Lilly Endowment was created by members of the Lilly family--were set up to function under small, closely knit boards composed largely of members of the family concerned and of their business associates. This was for a long time true of Lilly Endowment. Yet in recent years the Lilly Endowment Board has been enlarged and made more diverse. Today it includes only one member of the Lilly family (out of ten Board members). It has drawn in an increasing number of members from business and professional life unconnected with the other activities of the family, and with diverse interests, backgrounds and political affiliations. Thus it has moved over the years to be a truly public board with full decision-making power.

Obviously, the employed professional staff play big roles in foundation decision-making. They must do the screening, evaluating and recommending for the Board, and this involves the examination of an enormous number of applications, the rejection of most of them, and, in some cases, the modifying, refining and even the initiation of grant proposals. Overwhelmingly, in all the foundations I know anything about, the recommendations of the staff become ultimately the decisions of the Board. It is important, therefore, that the staff be broadly representative of the public. Even in our relatively small staff (35) we have professionals drawn from the law, the ministry, education, business, social welfare service, government

administration, accounting. We have a healthy representation of racial, religious, and political, socio-economic backgrounds--and, of course, both men and women. To have significant input from the broad society a foundation is intended to serve it needs a diverse staff.

In addition to the full-time staff, Lilly Endowment, like many other foundations, makes considerable use of consultants drawn from a variety of backgrounds. They are used to review grant proposals, to evaluate funded projects, to advise the board and staff on policies, even, on occasion, to make detailed recommendations for decision. They too provide a significant input from the broader public.

Perhaps one of the most significant ways in which a foundation can demonstrate its concern for genuine public involvement in its grant-making operation is through its style of administration. At Lilly Endowment we try to operate, insofar as is humanly possible, on an open-door policy. We are accessible to phone callers and to visitors who walk in off the street and we are approached by many of both every day. The mail requests and suggestions pour in in unbelievable volume every day. We endeavor to give every request serious attention. From time to time, we try to get people with related interests together, assisted by outside experts, to examine alternative approaches to a given problem. We constantly seek advice from a variety of professional, cultural, educational, religious and governmental leaders.

Behind all of this rather demanding, at times exhausting, style of open-door administration, we at Lilly Endowment try to operate on a philosophy of stewardship, as do other foundations I know. Others might state it differently, but our philosophy, I believe, as defined in a statement recently adopted by our Board of Directors is representative of the essential purposes of most major foundations. Let me close with the

following excerpts from that statement:

The concept of trusteeship must be the basis for the administration of any foundation. It is central to the philosophy on which Lilly Endowment operates.

Foundations exist under laws of the state and federal governments. They perform a public service and are granted certain rights and privileges for the performance of that service.

Foundations must be scrupulous, responsible and imaginative in discharging their trusteeship function. This is not merely noble, it is necessary. Only if foundations see their work as a public trust, and operate that way, will they survive. Meanwhile, they have opportunities for significant achievement given to few agencies in our whole society.

Foundations represent freedom and flexibility. Despite certain governmental constraints, foundations are remarkably free to interest themselves and invest their money in what worthy causes seem important to them. They can, if they feel it right and necessary, move with a speed governments can rarely approach. They also represent the decentralization and pluralism essential to a truly free society. They do not have to reflect a monolithic party line.

There are obviously many acceptable definitions of trusteeship. Lilly Endowment defines its trusteeship in its own terms and tries to live up to its own definition. We should not only do what we are legally required to do to fulfill our trusteeship obligations, we should set a still higher standard of responsibility than is demanded of us.

That "higher standard of responsibility" can be described in something more than generalities. That standard is shaped by the following principles:

1. Lilly Endowment funds will be distributed in such a way as to further the creation and maintenance of conditions and incentives that will encourage people to develop to their fullest potentials. We hope for both the improvement of human beings and the advancement of our society--not just the perpetuation of certain of society's existing institutions. We do not intend to be just a patron of worthy causes or a mere adjunct to the United Fund. Certain stop-gap ameliorative services we will always have to help support, but we must go

beyond those things toward preventive and curative measures for dealing with social problems.

2. Finitude is one of the givens of human existence. We are not God and cannot solve all human problems. No foundation can begin to do more than a small fraction of the good things it is asked to do. Therefore, the Endowment will impose clear limits on the range of its interests and program activities.
3. Lilly grants will be awarded in large measure as investments in effective people and good ideas. Efforts will be made to determine the quality of the people who seek grants, the quality of their proposals, and the practical possibilities that the proposals can be successfully carried out.
4. While giving consideration to any thoughtful proposal related to its fields of interest, Lilly Endowment will interpret its trusteeship responsibility as requiring it to seek out individuals and organizations that give promise of being able to deal in a significant way with the problems and issues of interest to the Endowment and will help them to develop their proposals. We will not merely react to applications that walk in off the street. Moreover, we will attempt to remain alert and watchful concerning issues, problems and emerging ideas that need to be worked on whether others initiate proposals or not.
5. Within manageable limits to its fields of interest, Lilly Endowment will endeavor to be both a national and international institution, even while it maintains a strong continuing interest in the City of Indianapolis and the State of Indiana. It will distribute its funds so as to serve human needs on a broad ecumenical, interracial, transcultural basis.
6. A significant part of our trusteeship responsibility is to engage in continuous and meaningful evaluation of the operation of projects we fund. Part of our accountability is to hold those who receive our grants to reasonable standards of both fiscal and project performance accountability.
7. A never-ending aspect of foundation trusteeship must be to maintain a constant watch on the changing needs and problems of society and an ongoing willingness to re-examine from time to time our program interests and policies.

TESTIMONY BEFORE
THE SENATE SUBCOMMITTEE ON FOUNDATIONS

DAVID F. FREEMAN

October 1, 1973

SUMMARY OF DISCUSSION

1. Description of operation of a special purpose foundation - the Southern Education Foundation.
2. Three types of cooperation between foundations - joint staffing or merger; associations of foundations; and joint support of particular projects.
3. Responsiveness to the public - board composition and use of consultants.
4. Public reporting and availability of information about grants.

TESTIMONY BEFORE

THE SENATE SUBCOMMITTEE ON FOUNDATIONS

DAVID F. FREEMAN

October 1, 1973

PANEL DISCUSSION #1

Mr. Chairman, I am David Freeman, President of the Council on Foundations. I am also President of a relatively small foundation, the Southern Education Foundation, about which I will have something to say later in my testimony. I welcome the opportunity to appear before this Committee and address some of the questions which the Committee has suggested for this panel.

Since my fellow panelists have already described the activities of three different types of foundations, let me round out that part of the picture by describing a fourth type - the special purpose foundation. The Southern Education Foundation, which traces its founding back to the Peabody Fund, established in 1867, has as its purpose the improvement of educational opportunity for blacks in the 13 Southern states. With an integrated Board and staff, it has pursued this purpose through scholarships, graduate fellowships, internship programs which it administers itself, conferences, publications and grants. The staff, based in Atlanta, keeps in close touch with state and local educational authorities as well as with Southern colleges and universities and attempts to gear both the operating and grant-making parts of the Foundation's program to current needs in the field.

One example of the kind of thing this type of specialized foundation is able to do relatively quickly with limited resources was the preparation and distribution, shortly after passage of the Education Acts

of 1964-5, of a looseleaf service which helped predominantly black colleges in the South to obtain their share of Federal funds. Another more recent program has helped several Southern states to train teachers for the just established pre-school and kindergarten programs in their public schools. As is true with other special purpose foundations, this type of activity makes the staff members themselves valuable resources of information, both for other foundations and for educational institutions.

Now let me shift gears and discuss specifically the types of relationships that exist between foundations and the way in which these relationships seem to be developing. There are three principal types of cooperation which the Council on Foundations has identified, and which it makes every effort to support. The first of these is cooperation between smaller unstaffed foundations to enable them to employ professional help in their grant-making programs and administration. The Southern Education Foundation itself is an early example of this, since it represents the merger of three funds with closely allied purposes and has since 1937 operated as a single entity with a professional staff.

Recently a second pattern of cooperation has developed. In such areas as Boston, Hartford, Chicago, Los Angeles, Minnesota, Michigan, and New Hampshire individual foundations and corporate givers have formed associations. Together they engage a small staff to improve their fact gathering capability, analyze area needs, and to maintain contact with government grant-making agencies, the public and applicant agencies and institutions. Such associations don't make grant decisions for their members but rather help them to get the facts they need to make their own decisions.

Frequently a community foundation in a particular city serves as the initiator of such groupings of foundations and helps with some of the initial administrative expenses.

These two types of close cooperative relationships are logical solutions to some of the problems smaller foundations face in meeting the new administrative and program requirements of the Tax Reform Act.

Another type of cooperation, one which the associations of foundations also frequently employ, is the pooling of grants from several foundations to finance a particular project which no one of them is in a position to fund itself. Here the pattern has been set by several of the largest and best known foundations, which have jointly supported very large and important philanthropic activities. One example worth mentioning is the "green revolution" - the extensive work in the development of new strains of rice and grains initiated by the Rockefeller Foundation but now supported jointly by that foundation, The Ford Foundation and others. Another more recent effort to work towards the solution of a major problem of our society is the formation of The Drug Abuse Council in 1972 with funding from the Carnegie Corporation, The Ford Foundation, Commonwealth Fund, Equitable Life Assurance Society and the Henry J. Kaiser Family Foundation.

Many other examples could be given of cooperative grant-making, not only between foundations but between foundations and government agencies. The development of the matching grant technique, now widely used in a number of federal programs, often requires this kind of cooperation and a recurring theme at the Council's annual meetings is that of cooperation in program areas with government.

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As the earlier speakers on this panel have suggested, many foundations are studying the composition of their boards and their methods of reaching policy decisions, in order to be as responsive as possible to the public interest. In some instances this has meant a broadening of the membership of foundation boards to include members of minority groups and increased representation of women. Other foundations have developed and used effectively a pattern of advisory committees and consultants to better inform their boards and staff of the needs in particular program areas. In this connection, the Council recently circulated to member and non-member foundations the result of a Gallup survey on public attitudes about foundations and the programs that the public wants foundations to support.

Since there are never enough funds in a particular foundation to meet all of the meritorious requests which a foundation receives, it is often difficult, and some feel unwise, to have direct representation of prospective grantee organizations on a particular board, but foundation leaders are acutely aware of the need to respond as flexibly as possible to the opportunities and needs presented to them.

Finally, let me add a few brief words to what Mr. Goheen has already said on the subject of informing the public. The Council and its sister agency, The Foundation Center, have long recognized the need to provide much better information about foundations to the general public as well as those who seek foundation grants. Since the passage of the Tax Reform Act with its requirements for disclosure of the essential facts about every foundation, both organizations have redoubled their efforts to encourage and assist organized philanthropy in telling

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its story. Specifically, The Foundation Center, which maintains libraries in New York and Washington, is now in the process of establishing regional collections of material on foundation grants, with a goal of 50 such collections throughout the United States. In addition, The Foundation Center has developed a capability to provide grant information on demand from a computerized data bank and has stepped up its publications program.

The Council cooperates with the Center through the publication in each issue of Foundation News of a grants index listing current grant activities divided by subject categories. In addition to the policy statement on the importance of public reporting referred to in Mr. Goheen's testimony, the Council has recently published a handbook on public information which has been widely disseminated to member and non-member foundations, and will later this year be conducting the third in a series of workshops on the how-to-do-it aspects of public reporting. The Council's own Annual Report, in addition to covering its own activities, attempts to present each year a picture of grant-making by a wide range of foundations, large and small.

In all these efforts we have been encouraged by the response of our members, but there is still much to do. At the last count, only some 350 of the grant-making foundations were publishing reports of their activities beyond the reports required by the Tax Reform Act.

As you've heard this morning, foundations do have interesting and positive stories to tell about their activities. We hope that many more of them can be led to effective and frequent public reporting.

SUMMARY OF STATEMENT OF ROBERT C. GUENZEL, DIRECTOR OF THE LINCOLN FOUNDATION, INC., AND CHAIRMAN OF THE COMMITTEE ON COMMUNITY FOUNDATIONS OF COUNCIL ON FOUNDATIONS, INC.

1. Community foundations are actively engaged in every area of philanthropy.
2. Community foundations emphasis originally was in areas compatible with United Fund activities. In recent years this emphasis has shifted to the funding of innovative programs for the preservation of the environment, promotion of cultural and artistic activities, and aid to those disadvantaged whether by race, language, poverty or physical or mental disabilities. This change in emphasis has occurred because of governmental activities in areas with which such foundations were formerly concerned and because of the recognition of a need for the funding of "risk" programs.
3. Recipients of grants from community foundations have been assisted in the initial fundings of their proposed programs and aided in adopting proper budgetary and administrative procedures.
4. Community foundations have provided the leadership in many communities in the cooperation between foundations and such cooperation now exists to a high degree.
5. Community foundations can continue to exist only if the public is involved as continuing financial support is generally an essential element to such foundations. Community foundations, therefore, generally have a continuing program of public information as well as a continuing search for innovative methods of involving the public in their activities.
6. Community foundations generally require written reports from grant recipients as to the use of such funds and most community foundations have a standard program of a follow-up investigation by the staff after a prescribed period of time with a report back to the Board of such foundation.

STATEMENT OF ROBERT C. GUENZEL, DIRECTOR OF THE LINCOLN
FOUNDATION, INC., A COMMUNITY FOUNDATION

This statement concerns itself with the area of community foundations in general and particularly with the activities and experiences of The Lincoln Foundation, Inc., which is a relatively small, three million dollars, and a relatively young, fifteen years, community foundation. However, the remarks, except as to individual specific activities, will apply generally to the community foundation field.

When community foundations first were conceived, shortly after the turn of the century, it was with the idea that charitable bequests or gifts by individuals in a community could be best utilized if continuing community direction were given to the pooled funds rather than a simple carrying out of the wishes of the long-dead donor under circumstances certain to change. The primary thrust of the activities of such foundations was initially in the broad area of social programs such as those operated by then community chests or United Funds. In recent years and months such program direction has taken a decided shift away from this area to much more divergent programming. This has been occasioned partially by the movement of government, both local and national, into fields formerly supported solely by private funding but, perhaps more importantly, by the recognition of community foundations that they should supply funds, primarily, in areas unsupported by other sources, either public or private. Thus, today, we see community foundations undertaking programs where the risk of failure is so high that they would not be properly the subject of the expenditure of public funds or of support of the United Fund agencies. In the past two years the primary emphasis in such programs has been in the area of environmental problems, minority development, local government studies, innovative drug abuse programs, and cultural activities.

From the foregoing it can be seen that the recipients of grants from community foundations are generally new entities in the process of organization to solve a new community need or existing entities that are developing a new program to meet a need not being met by others. The community foundation thus can provide the "seed" money to get the program underway

and can provide advice and assistance in administrative and budgetary procedures. In addition, of course, if the community foundation is doing its job properly it can advise applicants for grants of others who are attempting to meet the need or of existing agencies where a small expansion can better meet the need than by the creation of a totally new entity or agency. From this point of view the refusal or rejection of an application for a grant can sometimes be of more benefit to the community and the applicant in long range economies of community funds than anything else the community foundation could do.

In Lincoln, Nebraska, there are four major foundations (although it would probably be difficult to qualify them as "major" in other areas of the country). The three, other than the community foundation, have specific fields of interest and the executives of all communicate with each other with reference to grant applications. The obvious purpose of this is to avoid duplication of grant applications and to conserve community funds to the best purpose. In some instances cooperative grants have been made where two or more of the foundations would furnish a portion of the funds for a particular project. Generally, the community foundation has provided the catalyst for such cooperative endeavors. Nationally, the community foundations have provided the impetus for "clearing-house" activities among foundations in many communities. For example in San Francisco monthly luncheons are held of the executives of the foundations in the area.

A community foundation that does not involve the public in its activities will not survive. It is the essential element of a community foundation that continuing direction be given by the community to the use of the funds in the foundation. Further, the community foundation can grow only through the gifts from the community. It is true that a few of the major community foundations have received substantial bequests commensurate with the size of the cities in which they operate. Our gifts or bequests are commensurate with the size of our city, as well, and we are totally dependent upon a continuing gift program. Many of these are small - over the years of its existence we have received \$181,000 in gifts of from 1 to 10 dollars or so. The more a community foundation can involve the public in its activities the faster it will grow and the better job it can do in the community. Obviously the initial step is to have a Board of Directors broadly representative of the community, and if the community foundation has members

its membership should similarly reflect the total community. In order to further broaden the participation of the community in our decision making we have established several committees to deal with particular areas of grants. For example, we have the Educational Assistance Committee made up of professional and concerned lay persons in the field of higher education and administration to advise the foundation on grants in this specific field. A similar committee exists in the medical field. A most important example of such a committee is our Youth Advisory Committee made up of representatives from each of the five high schools in the City of Lincoln. Since youth is a fleeting thing we could devise no permanent membership in this area but this committee meets with us and any request for a grant affecting youth is referred to this committee for a study and a report.

A caveat must be noted with reference to the foregoing, however. Prospective donors must have confidence in the judgment and continuing stability of the community foundation or no donation or bequest will be made. The Board of the community foundation then should represent the total community but the leadership, probably, of the community elements. It is a problem that must be solved by balance and by innovative solutions.

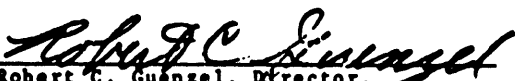
In order to keep the public informed as to our activities we make full use of the local newspapers. Stories are carried on every meeting held by the Foundation and the actions of the Foundation are reported. In addition, annual reports are published covering each year's activities and these reports are sent to local, state and national officials as well as a general mailing throughout the community and are available for public inspection at our office. Every operating community foundation in this country with which I am familiar makes such annual reports and sends them to officials at all levels of government as well as making other distributions thereof. Approximately every two years a representative of our Foundation participates in a program with the local Bar Association to continually remind the attorneys of our functions. Materials, including the annual report, with reference to the Foundation are made available at the local banks and other public or quasi-public places, including, for example, the office of the Mayor.

Following the making of a grant the grantee is required to file a written report upon the completion of the program or purpose for which the grant was made. At the end of a two-year period from the making of the grant the executive director reports to the Board meeting next following on the

results of the grant. Upon request by the grantee we will provide continuing assistance and advice in administration. We believe that we cannot expect each of our grants to meet with success. Indeed, we believe that we would not be fulfilling the true purpose of the community foundation if we only funded those programs where success was assured.

Community foundations are an important part of the field of philanthropy. Together with other foundations, private and corporate, they will continue to be a proper, necessary, and desirable part of the American society. I would, however, be less than candid if I did not point out that the growth of existing community foundations and the creation of new foundations of this nature has been hampered, substantially, in recent years by the federal government. I am sure that this has not been the intention of the Congress or the Administration, but this has been the result. After the passage of the many changes relating to foundations contained in the 1969 Act proposed regulations relating to community foundations were published and a lengthy hearing held thereon on December 7, 1971, a perhaps appropriate date. Thereafter, these proposed regulations were withdrawn and new regulations prepared. A committee of attorneys representing community foundations has had conferences with various parties concerned in drafting these new proposed regulations on occasions since the hearing. This committee stands ready to have further conferences with relation to any problems therein with anyone involved but we have not been asked to attend such conference, nor have we been informed of any difficulties or problems recently with such regulations. Nevertheless, to this date no regulations have been issued. With respect to community foundations great assistance could be provided to existing foundations and encouragement to the formation of new ones if proper direction could be given by the issuance of regulations compatible with both Congressional intent and sound community foundation practices.

Respectfully submitted,


Robert C. Guenzel, Director,
The Lincoln Foundation, Inc., and
Chairman of the Committee on
Community Foundations of the
Council on Foundations, Inc.

STATEMENT BY RAYMOND C. WIEBOLDT, JR.
PRESIDENT, WIEBOLDT FOUNDATION, CHICAGO, ILLINOIS
BEFORE THE SUBCOMMITTEE ON FOUNDATIONS,
FINANCE COMMITTEE, U.S. SENATE
OCTOBER 1, 1973

I am here as a representative of smaller and medium-size foundations -- those of us whose endowment and annual giving figures place us outside the category of the largest 100 or so foundations. We are different from them in many ways. We don't have large staffs; board members, like me, are very much involved, on a volunteer basis. The scope of our grants is usually limited; we often concentrate on support of organizations in our own local communities. Most of us are content to respond to requests for grants, rather than initiating programs.

Beyond such broad characteristics many of us may have in common, our foundations present a great variety of purposes and ways of doing things. That's how it should be; foundations play a useful role in preserving a practical everyday sense of pluralism in America. Let me describe briefly one example. The Wieboldt Foundation was established in 1920 by my grandfather and grandmother, Mr. and Mrs. William A. Wieboldt. They set aside \$4,500,000 as the endowment for the foundation. We have made grants through the intervening years totaling \$15,300,000, from both normal income and capital gains. Last year our grants totaled \$718,000, or about 64% of the \$11,000,000 average market value of the foundation's assets during the year. Our grants were all in the Chicago area, largely to organizations and agencies attempting to deal with some facet of urban problems for urban people. The foundation has a staff of three: executive director, administrative director and secretary.

Many of our grants now and for several years past have been to community organizations -- groups of citizens who want to get together and work towards some constructive goals for improving the quality of life in their own neighborhoods. Money in such cases is the least important ingredient, compared to the precious value of citizens' energies themselves, but it's a necessary enabling ingredient. A typical grant of \$10,000 or so would be used to help pay for the day-to-day expenses that have to be incurred to make a community organization work.

The activities we fund with such grants cover the whole scope of community life. Attempts to improve schools through citizen participation, new ways to create health services, developing new economic opportunities and job resources, are just a few examples. The communities involved vary a great deal too; all colors and creeds, all income levels are represented in our current grants to Chicago community groups.

We also make grants to professional agencies. Some are providing social services to individuals; we help where we can to maintain such services and yet also in efforts to find ways to get at root causes of problems. Other agencies with grants this year are in a variety of fields--a public interest law firm, a teachers' center, a group working on the potentials of cable television, a Puerto Rican Cultural Center bringing the art and craft of silk screening from its island heritage to Puerto Ricans in Chicago. These grants are investments in new energies coming forward to enrich our city and try to solve some of its problems.

It seems to me that this broad scope of activities funded by foundations is one of the clearest differences between the old days of philanthropy and the new. Urban people have higher expectations about themselves and their communities than ever before. Yet our cities are full of disappointments, full of functions and services that don't work. Organizations arise in every conceivable field to try to overcome the troubles, and they deserve attention and respect. Instead of being off in some corner of society concerned with something called charity, we are forced to be very much a part of the mainstream life of the city. From the standpoint of public accountability of foundations, this is a healthy change. To the extent that we are in that mainstream responding to needs that are being felt in communities, our priorities reflect the priorities of the people, rather than some set of priorities we have invented for ourselves in a vacuum.

We keep in close touch with our grantees. Our executive director makes this his most important activity, and board members frequently visit grantees and always receive and read progress reports. We evaluate the consequences of our grants largely through observation; we know what the grantee is trying to do because we have worked hard with him to understand and help articulate those objectives. By gaining the grantee's trust and sticking with him, we can see the successes, and the failures. We don't have much hard data in a statistical sense because we're not a research-oriented foundation. We are most of all interested in making grants that will enhance leadership qualities of people and their abilities to help others. Accomplishments with such purposes are hard to evaluate. But we can talk about specific new dialogues being established between police and community, new services being won for handicapped children, families being successfully encouraged to live in integrated neighborhoods, changes in urban renewal plans to reflect community wishes.

I think this close relationship with grantees is a style of practice that more and more foundations are turning to. We must, if we are going to be in touch enough with what's going on in our communities to make intelligent choices about grants.

We are also communicating more among ourselves. In Chicago, for instance, we have established the Chicago Foundations Group this year, to

exchange information, learn from each others' experiences, and help each other look at new opportunities for making our foundations useful in the public interest. About 40 foundations have been actively involved so far; the total amount granted by these 40 foundations in the most recent reported year was slightly more than \$19,000,000. We have had meetings so far about how to comply with the tax reform act, an analysis of where we as a group are giving our money, and what some of the options are in making grants to help work on urban problems. This month we will have a joint meeting with representatives of the National Endowment for the Arts, a nuts and bolts session on administrative practices in handling grant requests, and a meeting on how foundations can best relate to colleges and universities and vice versa. I feel the enthusiasm being shown by foundation board members as well as staff members, and the tangible benefits we can all see coming from the experience, are good indications of the sincerity of foundation people in trying to make foundations useful in our community.

The Wieboldt Foundation publishes an annual report and at least two interim lists of grants each year. We distribute these reports broadly in the community so people can know what we're doing. We are anxious to show that we are available as a resource. I spoke of being in the mainstream; we spend more time evaluating requests and performances out in communities with community people than we do in the office. When we get an application from a community group, we insist on finding out where that group stands in the community, who is involved, and to whom they are accountable. We feel that only in that way can we begin to be properly accountable to the community ourselves.

The Chicago Foundation's Group is also helping us and all the other foundations establish closer community relationships, not only because that's one of the major points of encouragement among the Group but also because we involve public representatives in our meetings. We find that when a dozen foundation representatives get together with a dozen community people involved in urban programs, for instance, the conversation can be a great deal more open and enlightening than the conventional one-to-one relationship. Everyone involved can get a clearer idea of his community responsibilities.

I can't let this occasion go by without remarking on the 1969 tax reform act. We find the new regulations fairly easy to live with; we are experienced enough and perhaps large enough to know how to comply with concepts such as expenditure responsibility without undue anxiety. We fear for the smaller or less experienced foundation, however; we beseech the government to work constructively with foundations and encourage them, rather than run them out of business with a lot of threats and red tape. As far as the tax is concerned, we pay it with great misgivings. The \$15,000 we paid this year meant at least one major grant we couldn't make; we were that much less effective as a useful community resource. We ask that the tax be eliminated or substantially reduced.

Thank you for the opportunity of appearing before you on this panel; I'd of course be glad to answer questions and help in any way I can.

To: Subcommittee on Foundations, Senate Finance Committee

From: Merrimon Cuninggim (Author, Private Money and Public Service,
and Foundation executive)

Subject: A Statement for the Hearings on Foundations, Panel No. 2,
October 1, 1973

Gentlemen: The five questions drawn up for consideration by this Panel are so large and important that the temptation, in light of my long-time experience in the foundation field, is to write a book in comment on them. Fortunately for me, the book has already been written; and it delights an author's heart, of course, that my book's sub-title, The Role of Foundations in American Society, happens by chance to be the theme chosen for this Panel.

In an effort to make this Statement as brief as possible, I will simply sketch out answers to the questions posed by the Subcommittee. In case elaboration should be desired, I will indicate where the various topics are discussed in my book; and will be happy to comment at greater length orally.

Question No. 1: How useful and/or necessary are foundations in American society today? What functions do they perform? Are these--or could these--functions be performed by other groups?

"Useful"? Very. The myriad "functions...they perform," in fulfillment of their over-arching function to enhance the general welfare, undoubtedly make immense contributions to the improvement of American society. No area of life is ignored--at least none that is legal and moral. (Chapter 4 of my book.)

This doesn't mean that everything that every foundation does is useful. Lots of the roughly 26,000 are small and often ineffective, and some of the big ones have not yet learned their proper role. But on balance the record of positive accomplishment is impressive. (Chapter 1, passim.)

"Necessary," however, is another matter. How strictly is the word being used? If it means, could we get along without foundations, the answer has to be Yes--and in the same limited sense we could get along without symphony orchestras, or research institutes, or maybe even some of our hospitals, schools and churches. At least some of the activities of foundations could indeed be performed by other groups if foundations were to get, or be put, out of business. At the present time there is no substitute for the assignment of generous private money to public service, which is the task of foundations; and if America feels that this is desirable, then in this sense I think we can say that foundations are necessary. (Chapters 1, 5 & 6, passim.)

Question No. 2: What are the negative aspects of foundations? What are they doing wrong?

It is important to discriminate between charges against foundations that the facts support and other charges that the facts don't support. What they are "doing wrong," and what they are accused of "doing wrong" are not the same thing. I shall touch briefly on both.

A number of the "negative aspects" have to do with the structure and financing of foundations: a) that they are said to be tax dodges; b) that they are used primarily for business and family advantage; c) that their investment policies run counter to the public interest; d) that they represent dangerous concentrations of power; e) that they are elitist in management and general outlook; and f) that they are not accountable to the public. (Chapter 2, and chapter 6, passim.)

Shorthand will have to substitute for a full, careful analysis; and my own answers will undoubtedly disagree with those of swashbuckling critics on one side

and nervous defenders on the other. I would welcome a chance to respond to these charges at greater length; here I can give only brief, summary judgments, as follows:

- In re a), foundations themselves are not tax dodges, but many donors may indeed have received excessive tax concessions in establishing their charitable funds.
- In re b), see question no. 4, below.
- In re c), unimaginative investment portfolios have been the norm, but the Tax Reform Act of 1969 effected an improvement here, and consequent pay-out to charity has been notably increased.
- In re d), leading foundations do have considerable influence in their fields of activity, but in my view the facts do not support the notion that their power is either massive or dangerous.
- In re e), elitism can be broadly documented, but many foundations, especially the larger ones, are beginning to do something about it.
- In re f), thanks to TRA 69 as well as to developments already under way at the time, foundations are now more accountable than ever before, though they still have a way to go.

All these seem to suggest the question, Are foundations serving as bulwarks of special privilege? In many an individual instance, the answer is undoubtedly Yes. For most of the large foundations, and on balance for the field as a whole, the answer, I believe, is No. But foundations can take only part of the credit for improvement in these matters; government regulation has brought about many desirable changes in the areas of structure and finance. (Chapters 2 & 6.)

In the areas of program and operating policy are other "negative aspects," alleged or real, that must be noted: g) that foundations don't spend enough; h) that they are secretive; i) that they engage in inconsequential work; j) that, conversely, they are effectively propagating extremism; k) that they indulge in partisan politics; and ell) that they don't monitor and evaluate their work as carefully as they should. (Chapter 3, & chapter 6, passim.)

Again, much needs to be said, but since answers must be pithy, then:

- In re g), TRA 69 has pretty much taken care of the problem of inadequate spending.

- In re h), foundations are no longer as secretive as formerly, courtesy of TRA 69, but many of them, especially a large proportion of the smaller ones, are unduly reticent.

- In re i), those who start from the premise that the work of foundations is inconsequential end up with it as their conclusion--which is simply to say that you can find what you are looking for, all the way from unimaginative and safe activities to courageous and even risky projects. My own view is that the routine outweighs the daring by a large margin--which is what one would probably have to say about any other type of organization specializing in public service.

- In re j), that foundations generally are engaging in extremism, whether of the left or right, is nonsense. Only a handful of valid examples can be discovered.

- In re k), almost as preposterous is the muted companion charge of political partisanship, in spite of the supposed heinous instances cited in

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Congressional hearings in 1969. Except for a very few indiscretions here and there, the facts don't support such a charge.

- In re ell), it is indeed true that, on the whole, foundations don't monitor and evaluate their work very well.

The summary question for the areas of program and operating policy might well be, Are foundations acting as agents of constructive change in society? With allowance for disappointments and failures, which all foundations know they have experienced, the on-balance answer, I believe, is Yes. (Chapters 3, 4 & 6.) But my phrasing of this question is slightly, and crucially, different from the wording of the next question posed by the Subcommittee.

Question No. 3: Fundamentally, are foundations a vehicle of the rich to use their economic resources in order to change our society? Should the rich be allowed to have this much influence?

There are, of course, two questions here, not just one. The phrasing of the second seems to pre-suppose that the answer to the first is affirmative; but that is seriously to oversimplify the situation.

The second question is easy as well as irrelevant: Rich men should not be allowed to mold the society to their pleasure, irrespective of the desires and needs of others--and neither should anybody else.

But there is simply no convincing evidence--and now I'm going back to the first question--that "fundamentally" wealthy people have successfully employed foundations to change things to their selfish liking, or that foundations are nothing more than the tools of the rich to win their will. This doesn't mean, of course, that individual men of wealth may not have tried such a ploy--and got away with it on occasion, just as in any other area or vocation in which shady activity is possible.

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But it does mean that reputable foundations, believing in constructive change, proceed to address the social problems chosen for attention, on the merits of the case, not on the whims of the parent rich or anybody else. Change? Yes. Insidious scheming by the rich to arrive at some foreordained conclusion? No. The overwhelming body of foundation activity, concentrated as it is in the large foundations, supports no such conception. (Chapters 2 & 3, passim.)

Question No. 4: Can we say that foundations are established in order to financially support programs to aid our society, or are they established merely as tax dodges and public relations vehicles for the persons establishing them?

The first thing to say is that it is not either-or. Though we always need to be careful in assigning motives to others, there are clearly many more motives for establishing foundations than simply the two cited, and even those two may not be mutually exclusive in every instance. As I've already noted, foundations do "aid our society," and their charters and programs suggest that this was at least one of the things their founders meant them to do. As I've also noted, rich men have often received tax concessions, and it would be naive to hold they didn't know they'd get them. The human condition being what it is, it's likely that setting up a foundation is nearly always a combination of generosity and selfishness. In my view, government policy should be aimed at encouraging the former and holding the latter in check; that is, reasonable tax incentives for genuine benevolence should be provided, and loopholes to allow the rich to escape their just share of taxes, on their spurious claim of being charitable, should be closed up.

(Chapters 1 & 5, passim.)

Once a foundation is established, it can hardly be said to be a tax dodge, for it pays the tax prescribed--even when as is now the case, the so-called audit fee of 4% raises twice as much as was originally anticipated when TRA 69

was passed, which amount itself proved to be twice as much as was needed to perform the desirable audits. But that's to get off the particular subject. The remaining item in this question has to do with whether it was the intent that foundations serve as "public relations vehicles for the persons establishing them." In motive? Perhaps. In actuality? Even more possible. That is, donors, their families, their businesses, their professional careers, can all be favored by the way in which foundations conduct their affairs. The benefit can go far beyond merely good public relations for the persons involved; and since opportunity for abuse of this sort still exists, in spite of TRA 69, the surprise is that there seems to have been so little in fact. But there is enough, in my view, to justify specific legislation. The 1965 Treasury Department's Report on Foundations recommended, among other things, the "broadening of foundation management" as a way of solving the problem of "close donor involvement," but this was the one recommendation of the Report that TRA 69 did not pick up. (Chapters 2, 5 & 6, passim.)

Question No. 5: Should foundations be considered self-perpetuating institutions in our society which are valuable and necessary today and in the future, or should a reasonable limit be put on their lives?

The choice is unreal. For example, it is not impossible that someone oppose perpetuity, yet still believe that foundations "are valuable and necessary today and in the future." And what is "a reasonable limit"? The question seems to be trying to get at something else which is not clarified.

"Self-perpetuating institutions" constitute the way America usually sets up its non-profit, public-service agencies. They aren't required, as a rule, either to liquidate by a certain time or to go on forever. They themselves make

the choice. If the suggestion were made they shouldn't go on forever, it would presumably be because they aren't serving the public, or because government or some other kind of agency could do their job better, or because the public interest is insufficiently represented in the determination of direction and program. Are these, perhaps, the concerns at which the question is aimed?

If so, let me say that I find it hard to imagine any "limit... on their lives" that would be "reasonable." Granting that foundations, like all other institutions, make mistakes and bad choices, they do serve the public remarkably well; any person whose eye might fall upon this page will have been benefitted in countless ways during his lifetime by foundation activity. Government or perhaps some other agency could indeed take over much of their work, of course, but this would represent a serious dilution of our pluralistic society in which ideally public and private segments work hand in hand. And if the real aim of a time-limitation is to secure the "broadening of foundation management," then specific legislation to that effect would be more effective and less dangerous than a cancellation of the time-honored and time-tested principle of perpetuity. Longevity brings experience, which more often than not makes for wise use of resources. A time limit for foundations would mean the waste of experience and less effective philanthropy. (Chapters 2 & 5, *passim*.)

Fritz F. Heimann

Foundations and Government: Perspectives for the Future

Any effort to consider the future of foundations must deal with the ultimate question: is there a continuing rationale for foundations? Foundations are in a difficult period in their history. The legislative battles of 1969 demonstrated that they have very limited political support and no effective popular constituency. The pervasive role of government programs means that the traditional rationale for foundations has largely disappeared. That rationale, though never very explicitly formulated, rested on the premise that there were spheres of activities in which the federal government had little or no active role, but which were of sufficient public interest to justify the use of tax incentives to stimulate private initiative.

In the face of political hostility, foundations could resign themselves to a low visibility role as disbursing agencies for noncontroversial projects whose priority is too low to secure government support. The financial pressures on all private sector institutions—museums, universities, hospitals, symphony orchestras—are so great that there would be no difficulty disbursing the \$1.5 to 2 billion per year which the foundations have to spend.

However, as tax-favored institutions, foundations are certain to be under renewed scrutiny, and will be required to justify their existence. Not having made anybody mad may not be an adequate defense. If foundations support only what is popular with poli-

ticians, their role will be insignificant because such projects will have access to much larger government funds. If they limit their grants to the institutions supported by individual giving, they are vulnerable to the attack that they are unnecessary middlemen.

In the long run, the only real justification for an institution is that it does things which others cannot do as well. Foundations have made many distinctive contributions in the past, but that was much easier before government agencies became active with vastly greater resources. Foundations must prove that they can continue to make distinctive contributions in an environment of massive governmental involvement if they are to develop sufficient public support to maintain their existence.

A Rationale for Foundations

I believe that their ability to make distinctive contributions is considerable. Of all of our institutions, foundations are potentially the most flexible, because they are least encumbered by internal or external constraints. This is of enormous value in a time of rapid change when most public and private institutions cannot cope with the need for change because of the constraints under which they operate.

Foundations are less constrained than any other type of organization by the pressures of their ongoing activities. Because they are essentially grant-making rather than operating institutions, their internal needs are quite modest and the bulk of their available funds are uncommitted. Thus, they have the potential to respond to change by launching new programs. Even though existing programs generate pressure for continued funding, it is far more difficult to eliminate or reduce a program carried on by an in-house staff than it is to cut support going to another organization. This phenomenon operates also with government programs and in the corporate world. The unique characteristic of foundations is the ratio of in-house expenditures to external grants. Only a very small percentage of the available funds are needed to keep the internal show running. Thus, the inertial force of ongoing activities is much smaller, and the ability to reallocate resources is correspondingly greater.

The fact that foundations are not required to raise money frees

them from many external pressures. An endowed foundation does not have to satisfy the demands of an external constituency, such as voters, customers, or advertisers, to assure its continued existence. It may be argued that, in view of political and other public criticism, foundations are hardly free from external pressure. There is, however, a basic difference between having to earn the active and continuing support of outside constituencies to remain in existence, and having to avoid activities which could trigger widespread opposition. The latter is at most a negative discipline. Our basic premise is still true: external constituencies do not impose any affirmative demands which foundations must meet.

The freedom from internal and external constraints gives foundations great flexibility to respond to the changing needs of American society. This flexibility provides the best basis for defining a useful role for foundations, because it suggests that there are activities which foundations can perform better than other institutions.

It is clearly easier for a foundation to engage in experimental activity than it is for a government agency. The system of checks and balances under which government programs are conceived and executed makes it extremely difficult to tolerate the failures that are an inevitable concomitant of experimentation. The same constraints also make it very difficult for government agencies to operate either on a small scale or on a long-time cycle. This introduces a twofold bias. An experimental program which looks as though it may produce negative results is likely to be killed too early. A program which appears promising may well be given broad application prematurely. For example, one of the major problems of such anti-poverty programs as community action was that experimental approaches were proliferated too early.

The very fact that foundations do not respond to a political constituency means that it is possible for them to sponsor a project in one community without being exposed to irresistible pressure to duplicate the experiment in other communities. Similarly, the freedom from political checks and balances, Budget Bureau reviews, appropriation committees, and partisan criticism means that a foundation can accept the consequences of an unsuccessful experiment without the risks inherent in a governmental program.

The absence of political checks and balances also means that foun-

dations can be much more selective in their allocation of resources. A foundation can decide to support only the best law school or hospital, or other institution, without being subjected to pressure for even-handed distribution to all similar institutions. It appears that some foundations have in recent years become concerned about charges of "elitism." This has led to the distribution of grants to broader groups of recipients. Without debating the wisdom of any particular program, I believe that foundations lose their ability to be distinctive if they adopt grant-making criteria which closely resemble those of government agencies.

Foundations can also enter sensitive or controversial areas more readily than government agencies. Strong opposition by a vocal minority can often stop a government program. Foundations can be considerably more venturesome. For example, foundations began working in the birth control field at least two decades before the government entered it. Most observers credit the initial work financed by foundations with laying the basis for the government's ultimate entry.

The development of higher-yield food grains is probably the greatest success of the foundation field since World War II. The crucial importance of increasing agricultural productivity in countries like India with rapidly growing populations and limited available land, was widely recognized. However, for several decades the dominant political interest in Washington was the disposal of United States agricultural surpluses. Increasing the productivity of foreign countries had no political support. Thus here, too, political inhibitions on governmental action created an opportunity for foundation initiatives.

The greater flexibility with which foundation programs can be administered provides opportunities in such fields as support for artists, where subjective judgments are inevitably more useful than objective criteria. Government-financed programs must necessarily be operated with relatively formal procedures. Thus, it is questionable whether government programs in the humanities and in the arts could, even with increased funding, be as successful as, for example, the fellowship program of the Guggenheim Foundation.

Another obvious opportunity is the field of religion, from which

the government is excluded by the Constitution. Here foundations can operate free from the competition of government programs. Surprisingly, relatively little foundation spending has gone for religious purposes.

It appears to be fashionable to be critical of large foundations which operate on a local, rather than a broader geographical scale. To me such a local emphasis would seem to be at least one justified response to the unequal competition with large-scale government programs. By concentrating on a limited area, a foundation is more likely to bring to bear meaningful expertise, and its available resources are more likely to have a perceptible impact.

To my mind, there are ample opportunities for foundations to play a role which is both unique and important. To play this role successfully requires first of all a realistic recognition of the role of government. This requires a much more sophisticated model than the simplistic "private sector-public sector" dichotomy with which the foundation literature abounds. Foundations must understand both the enormous scope and resources of government programs and their inherent limitations. Against this backdrop the role of foundations can be defined.

There is room for collaboration between foundations and government programs, as Richard Friedman suggests in his chapter. However, collaboration with government programs has its dangers. The role of being a junior partner in government-dominated programs does not provide an adequate solution to the future role of foundations. The traditional reluctance of many foundations to become closely involved with government-operated programs reflects a fear which, while perhaps exaggerated, is not unfounded in view of the much greater resources of the government, not merely in money but in other important factors, such as experienced manpower. The concern that foundations might lose any individuality or impact if their programs were closely coordinated with government programs cannot be dismissed. The reality, however, is that the government is active in most fields of foundation activity and unless foundations learn to operate in that environment there is very little scope left for them.

The Management of Foundations

Our discussion of the future role of foundations makes clear that there are no simple answers. Careful and sophisticated determinations must be made within each field of activity to find areas where foundations can make a distinctive contribution. The development of such programs is no job for dilettantes. A foundation which decides how to spend its money after the trustees have finished their drinks at an annual dinner is unlikely to be very effective. It does not follow from this that there is need for "professionalization in giving." What is required is detailed knowledge and convictions with respect to the particular field of activity, not expertise in the methodology and procedures of philanthropy. Effective philanthropy is serious work. However, if the donor or the trustees are willing to do the work, that's fine. If not, they should obtain the necessary help to make sure the job is done right.

The argument that "independent" professionals will necessarily do more useful work than the donor or his family is far from clear. Any judgment is bound to be impressionistic at best. However, even Waldemar Nielsen, whose book on *The Big Foundations* is strongly critical of donor control, describes various instances where highly productive programs were originated by donor-controlled foundations. In fact if the emphasis in foundation work should be on innovation, donors and trustees may at times be more venturesome than the foundation professionals. As one case in point, it is worth noting that John D. Rockefeller Jr. was unable to get the Rockefeller Foundation, of which he was then chairman, to become interested in the population problem. Because of his strong convictions regarding the importance of the subject, he finally established a separate organization, the Population Council, to work in this area. Only many years later, after the subject had become more widely recognized and much less controversial, did the Rockefeller Foundation itself begin to participate.

In a review of foundation activity in the field of economics, George Stigler made the following perceptive observations about foundation professionals:

The large foundations in general are staffed by men whose personal convictions on the proper type of research are fairly representative of the consensus of respectable professional opinion. It would be considered irresponsible or dangerous for a larger foundation to plunge on a large scale into an eccentric program, and men who seek to do this do not get on or stay on foundation staffs. This trait is probably due to the professionalization of the administration of large foundations and possibly also to their vulnerability to criticism.

People working for foundations, like beauticians and undertakers, want their work to be granted "professional" status. However, it is a gross oversimplification to associate good foundation work with professionals and bad foundation work with donor- and family-run foundations. The need for staff depends primarily on the complexity of the programs which are undertaken. Even a very large foundation can get along with little or no staff if it limits itself, for example, to making unrestricted grants to universities. A foundation which wishes to become involved in a substantial volume of complex activities will certainly require a staff.

Amending the Tax Law

One of the key issues for the future is whether and how the foundation provisions of the 1969 Tax Reform Act should be amended. The Act was the result of a complex process of political pulling and hauling and the results show it. There were some useful reforms, notably the payout requirement. While its formulation could be improved, the principle that there be a minimum level of payout to charity seems unassailable. It cured a serious flaw in the prior law. No one should get a current tax deduction when he creates a foundation, unless the foundation promptly commences its charitable activities and continues to maintain a minimum level of payout.

At the other end of the spectrum is the 4 percent tax on the investment income of foundations. It is an indefensible absurdity which should be repealed at the earliest opportunity. In fiscal year 1972 the Treasury collected over \$50 million from foundations. This amount was lost to charity. It was more than double the Treasury's

estimated cost for auditing all tax-exempt organizations. If the tax is not promptly repealed, there is a danger that, in accordance with Professor Parkinson's first law, the amount of work performed by the Internal Revenue Service will rise to the level necessary to eat up all the dollars available.

The restriction on transactions between foundations on the one hand and donors, trustees, and other "related persons" represents an exercise in overkill. A more sensible balance between the cure and the disease should be developed.

The requirement that foundations exercise "expenditure responsibility" when grants are made to organizations other than tax-exempt charitable organizations is sound. That it appears to be having the effect of discouraging grants to minority and poverty groups is a commentary on the administrative weakness or timidity of many foundations, not on the desirability of the requirement. Foundations should learn to live with the expenditure responsibility requirement and not use it as an excuse for failing to make grants which should receive adequate supervision.

Conversely, the fact that the Treasury has drafted fairly reasonable regulations interpreting the statutory restrictions on legislative activities, and that most foundations find they can live with these restrictions, should not divert attention from the inherent unsoundness of the restrictions. Congress does not need to be shielded from foundation-financed lobbying. Every other interest group is busy lobbying, including unions and corporations, churches and veterans' groups, and most powerfully of all, the executive branch of the government. The process is and should be wide open. There is no very persuasive reason for excluding foundation-financed inputs. They will add only a trickle to the torrent and their product will be no worse, and might occasionally be a little better and a little more disinterested, than most lobbying.

Professor Bittker's chapter demonstrates there is little or no logical or factual justification for most of the distinctions in treatment between foundations and other types of charitable organizations. Over a period of time the less favored status of foundations is likely to have a serious effect on the birth rate of new foundations. In particular, the restriction on the percentage of stock holdings in a corporation which may be owned by a corporation will almost

certainly have an adverse effect on the creation of large foundations. Here too we seem to have a case where Congress made the remedy more severe than the disease warrants. In all likelihood, the minimum payout requirement will cure the most serious dangers presented by foundation ownership of controlling blocks of stock; namely, failure to provide an adequate financial return to charity. I would be inclined to drop the excess business holding requirement until after the effects of the minimum payout requirement can be determined. If there still is a problem at that time, the more drastic remedy can be reimposed.

While hard proof is not available, the Tax Reform Act is probably having a sharp impact on the creation of very small foundations. These have constituted an overwhelming percentage of the total number of foundations. (In 1969 more than 80 percent of all foundations had less than \$500,000 in assets.) The legal and accounting requirements established by the 1969 law appear sufficiently burdensome to discourage the creation of small foundations. Tax and estate planners no longer bother with foundations when only a modest amount of money is involved. To my mind, this is a welcome development, which illustrates the serendipitous delights of our legislative process. Students of foundations have long questioned whether the same tax incentives which encourage the establishment of multimillion-dollar foundations should be available to individuals who create a foundation which, because of its small size, is bound to be nothing more than another checkbook for the donor's personal giving. Unfortunately, it has never been possible to draw a practical line of demarcation between the "incorporated checkbook" and the "real" foundation. Any size test—whether it be \$100,000 or \$1 million—has the political defect of looking like discrimination in favor of the very rich. Conceptual distinctions are even harder to define. The burden of paperwork created by the 1969 law seems to be accomplishing by indirect means what was impossible to do directly. It will probably take several years before we will know how high the entry barrier really is.

Congress should make a thorough review of the foundation provisions of the tax law. Such a review should preferably be undertaken as a separate matter and not, as in 1969, as part of a broad tax reform effort. The foundation provisions are very complex and

will require detailed attention by the Treasury Department and by the congressional committees responsible for tax legislation. If the foundation provisions are taken up as part of an omnibus package together with issues of greater fiscal impact or political sensitivity, the foundation provisions will not receive the attention they require. While something different from the 1969 amendments might emerge, the results would probably be another ill-considered response to then current charges and countercharges.

The Government as Regulator and the Role of the IRS

Because federal encouragement for foundations has come through tax incentives, the regulation of foundations has inevitably become the province of the Internal Revenue Service. However, the principal interest of the IRS is to bring dollars into the Treasury. As a result, its interest in foundations has been directed primarily to questions of fiscal abuse. Moreover, because the auditing of tax-exempt organizations is not a very productive way of bringing dollars into the Treasury, the IRS has, during much of its history, paid only scant attention even to the fiscal regulation of foundations. With continuing public concern about tax equity, the need for adequate policing of foundations is beyond argument. However, the need for additional tax audits hardly justifies the tax on foundation income.

Much more difficult than determining the proper level of policing of fiscal abuses are the issues raised by government regulation of foundation program activities. The 1969 law enacted more detailed restrictions on foundation programs. The mere existence of the statutory provisions means that some regulation to achieve compliance is necessary. Furthermore, because many of the provisions raise problems of interpretation, it is necessary to develop regulations which will enable foundations to find their way through the complex statutory maze. In the area of foundation programs, however, the role of the Internal Revenue Service is more questionable than in the field of fiscal abuses. Very few people would ordinarily consult a tax lawyer or tax accountant in order to define, for example, a meaningful line between proper educational activities and improper participation in politics.

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If we question the competence of the IRS in such areas, the issue is presented, if not the IRS, what other agency should do the job? Here we have a dilemma. It is true that some other agencies may have more sophistication than IRS with respect to questions raised by foundation program regulation. However, such sophistication is likely to have been obtained by engaging in government programs which in a real sense are competitive with those of foundations. Asking some branch of HEW to pass on the propriety of foundation programs is probably even less desirable than letting IRS do so. The alternative of setting up a new agency has its own problems. For one thing, do the problems really justify the creation of even a small new agency? Should we run the risk that an agency with a limited mandate will inevitably work to create a bigger job for itself?

As indicated earlier, I would cut back on the scope of program regulation. (By eliminating the restriction on legislative activities, some of the more insoluble definitional problems disappear.) On balance I would be inclined to leave the remaining program regulation to the Treasury, as the lesser evil. Benign or even uncomprehending neglect is probably better than overzealous attention.

While the lack of external constraints gives foundations flexibility to launch new and useful programs, it also leaves them free to continue old programs which have outlived their usefulness. That some percentage of foundation grants will be dull and unimaginative is inevitable. However, I question whether government regulation can do more than deal with the quantitative aspect of foundation work by insisting on a minimum payout level. I do not see any practical basis for government action with respect to the qualitative aspect of foundation work.

This presents almost insurmountable definitional problems. No group of legislators or administrators are likely to agree on any workable standards for distinguishing between good and bad foundation work. Even if by some miracle of the politics of consensus the definitional problem could be solved, the result would inevitably undermine the rationale for foundations previously suggested. If foundations were to spend their funds on the basis of government-defined standards of what is good and bad philanthropy, foundation programs will wind up resembling government programs. Unless we

are willing to let foundations spend their money differently from the way government agencies would spend it, there is no point having foundations. The IRS might as well collect the money and let the government spend it.

Perspective on Foundation Performance

Any study of the foundation field should conclude with some overall evaluation. Are foundations healthy or are they sick? Should the institution be encouraged, discouraged, or eliminated? Like all ultimate questions these are hard to answer in any meaningful way. Even to make an approach requires, first, a realization of the limitations of the evaluative process and, second, a fair perspective of the strengths and capabilities of foundations.

In the course of the work of the Peterson Commission, much time was spent wrestling with the question of how to make some overall evaluation of the work of foundations. In particular the possibility was considered of making a "cost-benefit analysis" comparing the cost of the tax subsidies with the benefits to society resulting from foundations. After consulting some of the foremost experts in the arcane techniques of cost-benefit analysis, it was concluded that the job was impossible. The number of indeterminable variables is just too large. Even the "cost" of foundations, in terms of lost taxes, is impossible to measure. If there would be no tax benefit for contributions to a foundation, would a donor give the same amount directly to his university or to some other tax-exempt organization? Would he buy a bigger yacht, or improve his wine cellar? Would he leave the money to his children and, if so, by taxable or non-taxable methods? Would he set up a foundation even without tax incentives? A number of the major foundations were created before there were any strong tax incentives for doing so.

The analysis becomes even more unfathomable when we go beyond the donor's options. Let us assume that there had been no tax incentive for foundations, and that foundation donors had not availed themselves of other opportunities to keep the money away from the tax collector—what would the government have done with the extra taxes? Would tax rates have been lower? Would the national debt be somewhat smaller? Would the government

have been impelled to spend more money in the fields in which foundations have been operating? If the latter is the case, would the money have been spent more or less productively than the way the foundations have spent it? It is self-evident that there are no good answers to any of these questions and that the whole notion of a cost-benefit analysis of the role of foundations is unworkable.

Accepting the reality that the role of the institution as a whole cannot be evaluated in any meaningful way, there is left the possibility of appraising the work of individual foundations and then somehow building up to a cumulative judgment of the institution. This is the approach taken by Waldemar Nielsen in his book *The Big Foundations*. He reviews the work of the 33 largest foundations, those which in 1970 had assets exceeding \$100 million. Based on that review Nielsen concludes that foundations are sick and malfunctioning institutions with little hope for recovery. He is willing to grant them a brief term of years in which to improve. Failing to achieve adequate improvement they should be allowed to expire.

Whether Nielsen's assessment of foundations is justified depends largely on one's judgment of American society as a whole. If one begins with a vision of a society overwhelmed by problems with which our existing institutions are incapable of coping, and then asks what the foundations are doing to prevent the apocalypse, the obvious answer is: not enough. However, is it reasonable to expect foundations to sponsor programs which will change the system? As Nielsen correctly points out, the foundations are very much a part of "the system" and are interconnected with many of our other private-sector institutions, including corporations, banks, and universities. They are also dependent on the continued favor of the government. To expect them to play the part of well-financed and well-mannered Nader's Raiders is hardly realistic.

In defense of Mr. Nielsen, it should be recognized that he does little more than take the foundations on their own terms. After a thorough immersion in the pretentious prose of foundation annual reports and other statements of purpose, he compares the accomplishments with the rhetoric. Not surprisingly he finds a large gap. I will grant that anyone who has suffered through as much foundation prose as Mr. Nielsen has deserves to get even. However, I question the perspectives underlying his analysis.

In order to achieve a realistic perspective on foundations, we ought to look at resources rather than rhetoric. The annual expenditures of foundations are in the range of \$1.5 to 2 billion. In a nation with a gross national product exceeding \$1 trillion, there are serious limits as to what can be accomplished by foundations. Furthermore, there are thousands of foundations—most of them very small—and their funds are spent over a wide range of activities. Even the Ford Foundation, whose size disturbs Mr. Nielsen sufficiently that he wants to break it up into three or four pieces, is hardly a big institution when we lift our view beyond the foundation field. When we use yardsticks other than financial resources, the size of foundations seems even less significant. The number of people employed by foundations is in the range of two to three thousand. Even Ford with a disproportionate total of the manpower has fewer than five hundred professional employees. I would suggest that the real starting point for the assessment of foundations is the recognition that we are dealing with institutions of modest resources which for a whole variety of reasons can exercise only limited influence.

How useful such organizations can be depends on one's perspective of the problems which need to be addressed. As already noted, if we start from the premise that our society is doomed without radical restructuring of all of our principal institutions, foundations are hardly relevant. It is true that the prophet Jonah was able to save Ninivch even without a foundation grant. However, he lived in another age and had connections which even the Ford Foundation is unable to draw upon.

If evolutionary change, rather than radical overhaul is required, then an institution which is a part of the system, but free from many of the constraints of other institutions, can make some useful contributions. Financing the development of improved food grains at a time when the Department of Agriculture would not do so, supporting the creation of children's TV programs better than those which are produced within the profit limitation of commercial TV, sponsoring research in birth control when government was immobilized, are all very useful. There are no reasons to believe that foundations cannot continue to make similar contributions.

To my mind foundations have a useful role because we have

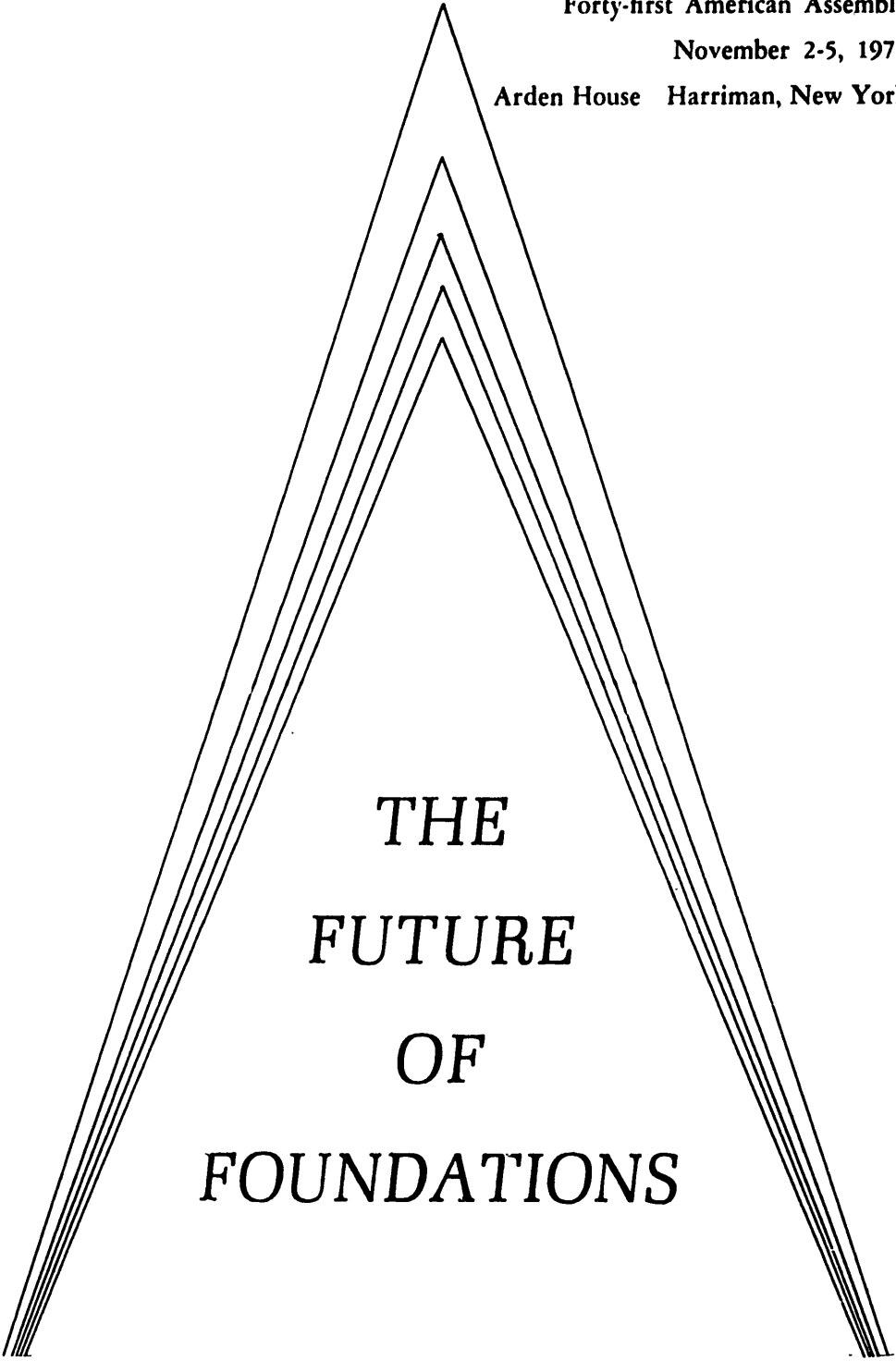
an extraordinarily complex society whose problems must be addressed in a wide variety of ways. Even though many of our problems are interrelated, there are no large, simple solutions. Foundations are important because they are different from other institutions in that they are largely free from the internal and external constraints which tend to keep other organizations in their accustomed orbits. This gives them the potential to address a great variety of problems to which other institutions are not attending. One of the most difficult challenges for the leaders of the foundation field is to inspire foundations to come close to realizing their potential, without at the same time elevating the level of rhetoric to a point where totally unrealistic expectations and anxieties are aroused.

At this time of uncertainties, it seems appropriate to recall the wise words of William the Silent, at the beginning of the Eighty Years War:

It is not necessary to hope in order to undertake.

It is not necessary to succeed in order to persevere.

Report of the
Forty-first American Assembly
November 2-5, 1972
Arden House Harriman, New York



THE
FUTURE
OF
FOUNDATIONS

The American Assembly
Columbia University

The volume *The Future of Foundations* (ed. Heimann), containing the chapters described on the next page, will appear in public print early in 1973, and may be ordered from the publisher, Prentice-Hall, Inc., Englewood Cliffs, N. J. 07632.

P R E F A C E

The Forty-first American Assembly met at Arden House, Harriman, New York, November 2-5, 1972 to consider *The Future of Foundations*. The participants, 72 Americans, came from all sections of the nation and represented various pursuits and viewpoints: from the foundations, business, education, communications, government, the legal profession (bench and bar), the medical, clerical and military professions and civic organizations. For three days they discussed in depth the rationale for foundations, their structure and operation: they assessed government regulation of foundations and considered interaction between foundations and government programs. On the fourth day, in plenary session, they reviewed the report which appears on these pages.

During the course of the Assembly, formal addresses were given by H. E. Soedjatmoko of Indonesia, President John H. Knowles of The Rockefeller Foundation, Under Secretary of the Treasury Edwin S. Cohen, and U.S. Congressman Barber Conable of the House Ways and Means Committee.

Under the editorial supervision of Fritz F. Heimann, background papers were prepared as advance reading for the Assembly as follows:

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|---|----------------------|
| 1. <i>The Foundation: "A Special American Institution"</i> | Thomas Parrish |
| 2. <i>Foundations and Social Activism</i> | Jeffrey Hart |
| 3. <i>Foundations and Public Controversy</i> | John G. Simon |
| 4. <i>1969 Tax Reforms Reconsidered</i> | John R. Labovitz |
| 5. <i>Should Foundations be Third-Class Charities?</i> | Boris I. Bittker |
| 6. <i>Private Foundation-Government Relationships</i> | Richard E. Friedman |
| 7. <i>Perspectives on Internal Functioning of Foundations</i> | H. Thomas James |
| 8. <i>Do We Know What We Are Doing?</i> | Orville G. Brim, Jr. |

Regional Assemblies, making use of American Assembly conference techniques, will be held across the nation with the cooperation of other educational institutions.

The report which follows reflects the broad consensus of the participants in their private capacities, reached after several days of organized discussion of a prepared agenda. The American Assembly itself, a non-partisan educational forum, takes no official position on matters it presents for public discussion. The partial funding of the program by the following persons and organizations is much appreciated, but it should not be construed that they necessarily share the opinions contained herein: DeWitt Wallace, Douglas Dillon, Robert O. Anderson, Robert W. Woodruff, The Rockefeller Foundation, the Henry Luce Foundation, and the William Benton Foundation.

CLIFFORD C. NELSON
President
 The American Assembly

FINAL REPORT
of the
FORTY-FIRST AMERICAN ASSEMBLY

At the close of their discussions the participants in the Forty-first American Assembly, on *The Future of Foundations*, at Arden House, Harriman, New York, November 2-5, 1972, reviewed as a group the following statement. The statement represents general agreement; however no one was asked to sign it. Furthermore it should not be assumed that every participant subscribes to every recommendation.

Foundations are privately managed sources of funds dedicated to public purposes. There are more than 25,000 grant-making foundations, and the existence of such decentralized sources of money is of great importance to our society and particularly to the nonprofit sector. There is great diversity among foundations. Only a few are large: most are quite small. Few people have a clear conception of what the word *foundation** means or what foundations do.

Since the publicized foundations are usually linked to names of great wealth, there is a widespread assumption that foundations have great influence in our society. This has led to unwarranted concern over their supposed power. The foundations themselves are partly to blame, because of the rhetoric they have used to describe their own activities.

Actually, even the larger foundations are quite small when compared with such organizations as government agencies and business corporations. Total assets of all foundations amount to about \$25 billion, and their annual grants are in the \$1.5 to \$2 billion range. By comparison, the annual expenditures of the Department of Health, Education and Welfare are approximately \$30 billion. The Ford Foundation, with assets of \$3.4 billion and annual expenditures in the \$250-million range, is disproportionate in size only by comparison with other foundations.

One major consideration in appraising foundations is the enormous expansion of governmental activities during the past generation. Government agencies are active with vastly larger funds in essentially all areas in which foundations work. Foundation programs inevitably interact with government programs, and there is opportunity for both collaboration and conflict. This makes the work of foundations at once more difficult and more challenging; yet foundations as diversified and decentralized sources of funds will continue to have an important role in the future.

Because foundation resources can be allocated with greater flexibility than those of most other institutions, they possess a special potential for responding to the changing needs of society, including the financing of experimentation, which is of great significance at a time of rapid change.

*The deliberations of the Assembly focused primarily on private grant-making foundations and these recommendations should be read in that light.

But it is also of importance to the health of society that foundations continue to support other nonprofit institutions, particularly in the fields of education, science and culture. At a time when such institutions are encountering severe financial difficulties, continued help is essential.

Too often foundations are inaccessible and their decision-making processes mysterious and arbitrary. Foundations must perform their role responsibly, openly and in the public interest.

We therefore make the following recommendations:

1. *Responsiveness to the Public Interest.* Many foundations, large and small, are not sufficiently exposed to the wide range of public interests that they wish to serve. Action should be taken to reduce this isolation. There are many methods to achieve systematic and balanced exposure to public concerns. Specifically, foundations should seek social and economic diversification in their trustees; should meet with, rather than retreat from, their critics; should invite critiques of their programs by outside review panels; should have deliberate policies producing trustee, and where appropriate, staff turnover; and should periodically meet with representative unsuccessful grant applicants to hear their views.

Foundations should take the initiative in developing services that will enable them to become more useful to the public. To the extent feasible, foundations should offer a wide range of counseling and consulting services to applicants, grantees and other interested parties. Better information systems need to be developed. Organizations serving the foundation should be strengthened and should invite public participation in their work. Active clearing house operations are needed, and much more activity among foundations should take place.

2. *Communications.* To improve their own operations and to better serve the public, foundations must take positive steps to minimize secretiveness. Adequate disclosure of their activities, including their financial affairs, is essential. However, because annual reports will not be widely read — and, in any case, are an inadequate device — foundations must explore other methods of communication with the objective of encouraging greater interest, response and criticism. The forms of communication should vary with the foundation's program and should be directed both to the general public and to more specialized publics such as professional groups and potential grantees of all kinds.

3. *Relations with Grantees.* The relation between foundations and their grantees is a sensitive one, and foundations should be careful not to overstep the proper bounds. In the case of grants to well-established organizations, foundations should, as a general rule, not go beyond a review of the grantees' expenditures and evaluation of the work, except where the common interest of the foundation and the grantee requires closer and more continuous consultation. Foundations should provide less well-established organizations with assistance as needed. Foundations should view themselves as service resources for grantees as well as providers of funds.

4. *Staffwork.* Effective foundation work requires a high degree of competence and diligence. Whether a professional staff is required by a foundation depends on the nature of the foundation, its program, and the time and attention which trustees can bring to the work. The most important element is the quality of the work, not whether it is done by trustees, professional staff or outside consultants. The Council on Foundations and community foundations, as well as the larger foundations, should take steps to assist smaller foundations by making advice and consultation available to them.

5. *Self-dealing Transactions.* There must be strict controls to assure the avoidance of self-dealing transactions between the donor and the foundation. However, some of the prohibitions embodied in the present tax law have resulted in unintended and inappropriate rigidity when applied to certain forms of indirect relationships. The law should be modified to eliminate these rigidities.

6. *Payout Requirement.* Foundations should be required to make adequate annual grants. This recognizes that the present problems of our society are sufficiently serious that available philanthropic resources, including reasonable return on endowments, should be currently utilized. We do not at this time recommend any change in the present annual payout requirement currently set at 5.5 percent by the Treasury Department; however, it should be re-examined after additional experience has been obtained.

7. *Prohibition on Political Activities.* No financial contributions or other assistance should be provided by foundations which could reasonably be construed as aiding a party, a candidate or advocating a specific result in a referendum issue in any election.

8. *Legislative Issues.* Foundations should be free to sponsor the study and discussion of public issues, even when such issues are taken up by Congress or other legislative bodies. They should also be free to appear and testify before legislative bodies. However, foundations should not engage in grass-roots lobbying. This does not preclude foundations informing members of Congress and the public of foundation activities.

9. *Support of Litigation.* Foundations should be able to support litigation, such as that carried on by public interest lawfirms, as permitted under present law.

10. *Government Agencies.* We endorse the Congressional decision not to restrict foundation interaction with regulatory and other executive agencies at the federal, state and local levels. Foundations should avail themselves of appropriate opportunities to work in partnership with government agencies, to support evaluation and monitoring of government programs, and to fund competitive programs in fields of interaction between government agencies and foundations. Adequate mechanisms for information exchanges should be developed.

11. *Government Regulation of Foundations.* The primary objective of government regulation of foundations should be the prevention of self-dealing and other types of financial abuse. Such regulation is essential to assure that foundation funds are used for public purposes and that public confidence in foundations is maintained. Regulation to prevent fiscal abuses should be carried out by the Internal Revenue Service. The importance of federal regulation should not obscure the need for effective self-regulation.

The government should exercise restraint in the regulation of foundation program activities. Such regulation, unlike the prevention of fiscal abuses, presents a threat to the integrity of private initiative. The more foundation programs are hemmed in by government regulations, the more will foundation activities resemble government programs and thereby lose one of their reasons for being.

12. *Differential Tax Incentives.* We question the soundness of the differences in tax incentives between foundations and other charities established by the 1969 tax legislation. The Treasury Department should collect data to permit an evaluation of the effects of the 1969 amendments on total philanthropic giving and on gifts to foundations as compared with gifts to other types of charitable organizations. Concern was expressed about provisions in the law that may adversely affect the incentives for establishing new foundations, particularly the provisions regarding the donation of appreciated property and the restrictions on the holding of control stock. From the public's point of view, the new energy and new ideas that can come from the establishment of new foundations must be encouraged.

13. *Role of Donor.* The opportunity for active involvement by donors is an important incentive for the creation of new foundations. Therefore restrictions on the role of donors are likely to reduce the creation of new foundations. However, over a reasonable period of time after their creation, foundations should take steps to reduce the influence of donors.

14. *Control Stock.* To encourage the creation of new foundations, ownership of controlling blocks of stock in business corporations should be permitted for a reasonable period of time.

15. *Tax on Foundations.* The tax on foundation income reduces the flow of funds for charitable programs and represents an inappropriate diversion of philanthropic funds to the government (over \$50 million in fiscal year 1972). The tax is unsound in principle and should be repealed.

Foundations should not be singled out for an audit charge. If such charges are used, they should not exceed actual audit costs.

16. *Size Restrictions.* No minimum- or maximum-size restrictions should be imposed on foundations.

17. *Philanthropic Policy.* Government action with respect to foundations

requires the recognition of broad social policies which transcend specialized tax concerns. To achieve this objective, an advisory committee on philanthropy should be established. The committee should include representatives of various fields of philanthropy (such as education, social welfare and health), recipients and donors, government officials working in these fields, members of Congress and representatives of the general public. The advisory committee should report to the Secretary of the Treasury and should issue regular publications for general readership.

In addition, there is need for some form of review to suggest how best this society can support its vital, nonprofit institutions, many of which face major curtailment or bankruptcy. Such a basic review should develop long-term formulas for balancing adequate governmental and philanthropic support. This may require suggestions for new institutions and mechanisms that avoid inappropriate governmental interference and make more widely available the benefits and productivity of the nonprofit world.

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ABOUT THE AMERICAN ASSEMBLY

The American Assembly was established by Dwight D. Eisenhower at Columbia University in 1950. It holds nonpartisan meetings and publishes authoritative books to illuminate issues of United States policy.

An affiliate of Columbia, with offices in the Graduate School of Business, the Assembly is a national, educational institution incorporated in the State of New York.

The Assembly seeks to provide information, stimulate discussion, and evoke independent conclusions in matters of vital public interest.

AMERICAN ASSEMBLY SESSIONS

At least two national programs are initiated each year. Authorities are retained to write background papers presenting essential data and defining the main issues in each subject.

About 60 men and women representing a broad range of experience, competence, and American leadership meet for several days to discuss the Assembly topic and consider alternatives for national policy.

All Assemblies follow the same procedure. The background papers are sent to participants in advance of the Assembly. The Assembly meets in small groups for four or five lengthy periods. All groups use the same agenda. At the close of these informal sessions participants adopt in plenary session a final report of findings and recommendations.

Regional, state, and local Assemblies are held following the national session at Arden House. Assemblies have also been held in England, Switzerland, Malaysia, Canada, the Caribbean, South America, Central America, the Philippines, and Japan. Over one hundred institutions have cosponsored one or more Assemblies.

ARDEN HOUSE

Home of The American Assembly and scene of the national sessions is Arden House, which was given to Columbia University in 1950 by W. Averell Harriman. E. Roland Harriman joined his brother in contributing toward adaptation of the property for conference purposes. The buildings and surrounding land, known as the Harriman Campus of Columbia University, are 50 miles north of New York City.

Arden House is a distinguished conference center. It is self-supporting and operates throughout the year for use by organizations with educational objectives. The American Assembly is a tenant of this Columbia University facility only during Assembly sessions.

AMERICAN ASSEMBLY BOOKS

The background papers for each Assembly program are published in cloth and paperbound editions for use by individuals, libraries, businesses, public agencies, nongovernmental organizations, educational institutions, discussion and service groups. In this way the deliberations of Assembly sessions are continued and extended. Subjects to date are:

- 1951 — United States-Western Europe Relationships
- 1952 — Inflation
- 1953 — Economic Security for Americans
- 1954 — The United States' Stake in the United Nations
 - The Federal Government Service
- 1955 — United States Agriculture
 - The Forty-eight States
- 1956 — The Representation of the United States Abroad
 - The United States and the Far East
- 1957 — International Stability and Progress
 - Atoms for Power
- 1958 — The United States and Africa
 - United States Monetary Policy
- 1959 — Wages, Prices, Profits, and Productivity
 - The United States and Latin America
- 1960 — The Federal Government and Higher Education
 - The Secretary of State
 - Goals for Americans
- 1961 — Arms Control: Issues for the Public
 - Outer Space: Prospects for Man and Society
- 1962 — Automation and Technological Change
 - Cultural Affairs and Foreign Relations
- 1963 — The Population Dilemma
 - The United States and the Middle East
- 1964 — The United States and Canada
 - The Congress and America's Future
- 1965 — The Courts, the Public, and the Law Explosion
 - The United States and Japan
- 1966 — State Legislatures in American Politics
 - A World of Nuclear Powers?
 - The United States and the Philippines
 - Challenges to Collective Bargaining
- 1967 — The United States and Eastern Europe
 - Ombudsmen for American Government?
- 1968 — Uses of the Seas
 - Law in a Changing America
 - Overcoming World Hunger
- 1969 — Black Economic Development
 - The States and the Urban Crisis
- 1970 — The Health of Americans
 - The United States and the Caribbean
- 1971 — The Future of American Transportation
 - Public Workers and Public Unions
- 1972 — The Future of Foundations
 - The American Correctional System

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TESTIMONY ON FOUNDATIONS

DELIVERED BY M. CARL HOLMAN, PRESIDENT
NATIONAL URBAN COALITION

TO

SENATE SUBCOMMITTEE ON FOUNDATIONS
OCTOBER 1, 1973

Some of the questions which generally arise concerning foundations I find difficult to deal with, because they seem to assume that foundations have a monolithic quality which does not square with my admittedly limited experience. On the occasions when I have had to deal with or contemplate foundations I have been struck, as much as by anything else, not only with the differences between one foundation and another, but with the variations in the way a single foundation may respond to a given problem or need. As a representative of a nonprofit organization, I have from time to time wished that foundations would behave in a manner more compatible with our needs and desires. But I doubt that in the long run that would be a healthy state of affairs.

I believe that foundations are an imperfect but vital and necessary part of our society. First of all, they stimulate and permit the private sector to play an active role in meeting the social and economic needs of the nation and of particular localities or regions. Foundations are in the American tradition of diversity and plurality, providing initiatives and alternatives not available in countries where almost everything is done by the government.

Moreover, foundations can often respond more quickly to emerging problems and issues than can either government or corporations, which may be limited by political priorities and realities, or by overriding obligations to stockholders. Lacking some of the constraints faced by government and business, foundations can be - and many of them are - flexible, innovative and

experimental, dealing with issues that cannot be readily touched by other agencies.

For example, foundations were active in the family planning field at least twenty years before government was, and their pioneering work laid the way for ultimate government involvement. The same could be said of other advances in health and medicine. The support by the Ford and Rockefeller foundations of the effort to produce higher-yield foodgrains to meet international food shortages, occurred during the years when the U.S. government was focusing on limiting food production and disposing of surplus food, and had little interest in increasing food productivity of other countries. Now that the world is experiencing a food crisis, there are amazing new grains available, thanks to the efforts supported by those foundations. It was the support of foundations, too, which sparked investigation and revelation of the nature and extent of hunger in America.

Anecdotal critics to the contrary notwithstanding, it was certain foundations that helped spare this nation even more destructive race and class relations than we have experienced; provided higher education and special training and leadership opportunities for certain segments of the population that would otherwise have been denied—with great human loss to the country; which supported American art and culture at a time when our government was totally uninvolved, and when other nations were providing such support as a matter of course.

And let me state my firm belief that, despite some mistakes or failures, certain foundations have laid the groundwork for sounder social policy and have helped offset, in some measure, the feeling of some elements in our society that government is inimical to their interests, or inaccessible. I maintain that, with our often relatively dismal showing when the level of political participation by our citizenry is compared to that of other modern democratic nations, foundation-supported efforts at voter registration and voter education have, on balance, made our politics more representative and more broadly responsive. The current public majority opinion in favor of Federal support of campaigns, like earlier indications of public sentiment for simplified access to the ballot and for opportunities to run for office, reflect something more than reaction to current allegations of abuses. There is now at least the possibility that the Congress and the Executive Branch may ultimately move to genuine reform of the present grievously inadequate budget process.

This development rests in part on the foundation-supported efforts of the Coalition and others to throw light on the need better to understand and to reform that process. More people are beginning to see the existing and potential significance of the Federal Budget as a more responsible and effective means of setting national priorities.

I would be the first to say that not all foundations . . . have played what I consider to be the kinds of basically useful roles in the public interest which I have tried to sketch. Too many foundations have in the past spent too little of their money, and in this regard the Tax Act of 1969 performed a useful function.

That legislation also caused many foundations to open up their operations, and join those foundations which were already providing a public accounting of their activities. To the degree that foundations have been used as tax dodges, I'm certain that the current legislation makes that much less possible.

On the other hand, I find it very hard to believe that foundations represent any substantial threat as a means employed by the richⁿ to use their economic power to change our society.ⁿ I have read that what foundations give amounts to less than two-tenths of one percent of the Gross National product and that their total worth represents two percent of the GNP. To my knowledge, few foundations have ever pooled their relatively modest resources to "change society" in the radically Left direction critics usually suggest, or in radically Right directions for that matter. The exceptions, I think, can be dealt with without straitjacketing everybody. Really fundamental tax reform would have targets other than foundations.

The faults I would find with foundations may not be the ones which others, differently situated, will see. Aside from the lamentable fact that not all of them have the wisdom to fund the Coalitions and their good works, or to care about urban problems, many of them share with government the tendency to embark for a short while on supporting a possible answer to a serious problem, only to abandon ship before the program or approach has had sufficient time to prove itself out.

Many corporations plan and implement three to five to ten years ahead. Most foundations and governments are very often tied to testing one-year solutions to problems decades in the making and resistant to twelve-month miracles. On the other hand, foundations certainly should wrestle harder with the problem of evaluating, within reasonable limits and without snatching open the oven doors every minute or so, what they intended to accomplish with their money and how it all seems to be working out. This is an exercise which seems to me not to require Federal legislation.

On the question of limiting the life of a foundation I think it would be useful for the Committee to weigh the pros and cons of this argument, as there is substance on both sides.

Factors supporting arguments to limit foundations' lives to 25 or 50 years include:

. It would discourage foundations from investing large amounts of money in impressive buildings for themselves. (Actually, only a handful of the 20,000 foundations have the funds for erecting such buildings anyway, and several of these operate in rented quarters.)

. It would keep foundations from perpetually controlling the funds that some critics view as potentially sinister. (Viewed in the overall context of our trillion-dollar annual economy, the total assets of all foundations, which is less than \$30 billion, could obviously not be a controlling factor.)

Arguments favoring the perpetuity of foundations are:

. It takes time to train and season good executives who with the least amount of funds can get the best results by knowingly examining proposals and following up on the programs of the ones which are funded.

. Even if a foundation keeps its name and endowment, its control and management change because of mortality, new board members, changing priorities.

I am one of those who feel that an unfortunate consequence of the 1969 Tax Act has been an increase in uncertainty and caution, sometimes bordering on cowardice, among a great many foundations. Whether this was ever intended or not, some foundations, rather than risk trouble, seem to have taken on only the safest and least controversial areas of concern. Meanwhile, minorities and others who see themselves as relatively powerless and cut off, as others are not -- including some non-foundation tax exempt groups -- are understandably skeptical about some aspects of the Act and proposals to further tighten governmental oversight and control. They see a worsening of their relative disadvantage when it comes to understanding and exerting some influence on public actions which may help or hurt them.

I think most of them would agree with me that, on balance, the wiser and juster course would be to encourage, not restrict, foundations in supporting the programs and activities that are designed to bring about a healthier American society.

I would be happy to respond to any questions you might have.

Summary of Points in
the Attached Statement
of Howard R. Dressner

1. Continuing review of the practical effects of the Tax Reform Act of 1969 on private foundations, of which these hearings are an example, is important. It is also important that foundations review their own activities and that the Congress be fully informed.
2. In general, the Tax Reform Act of 1969 has helped preserve and encourage the purposes and best traditions of philanthropy.
3. Three main restrictions of the Act relating to foundation programming are:
 - a) Influencing Legislation
 - (i) The Act specifically recognizes that objective nonpartisan study and research is well within the scope of legitimate philanthropic activity regardless of its subject matter.
 - (ii) These hearings can help make the public more aware of the legitimate role of foundations in supporting nonpartisan objective studies on significant public issues.
 - b) Grants to Individuals

Although the Act has imposed greater administrative requirements, foundations should not abandon the time-honored philanthropic practice of assisting talented individuals.
 - c) Expenditure Responsibility
 - (i) In cases where grants are small the expenditure responsibility requirements impose relatively large costs on both grantor and grantee. Perhaps expenditure responsibility could be waived for small grants.
 - (ii) Congress may also wish to reexamine the practical effects of classifying non-grant-making charitable organizations as "private foundations".
4. The Tax Reform Act has not only provided useful rules but has led to constructive self-examination by foundations. Hopefully it will lead to increased understanding of how foundations operate by the Congress and the public.

Statement by Howard R. Dressner
Secretary and General Counsel
The Ford Foundation

Subcommittee on Foundations
Senate Committee on Finance

October 2, 1973

I am pleased to respond to the request of the Chairman of the Subcommittee to participate in this hearing.

My name is Howard Dressner. As Secretary and General Counsel of the Ford Foundation, my duties include legal and administrative oversight of the grant-making process; among other tasks, assuring the Foundation's compliance with the Internal Revenue Code, counseling our program staff in the formulation of relevant guidelines and procedures, responding to questions that arise under the 1969 legislation, and verifying the tax status and classification of prospective grantees.

I will confine this opening statement to the effects of that part of the Act containing what have come to be known informally as "program restrictions" on private foundations. During the panel discussion I shall of course be glad to respond to questions.

At the outset, let me say that we welcome this hearing as a further opportunity to advance understanding of the practical effects of the Tax Reform Act of 1969. Since the adoption of this important, complex, and -- for the philanthropic community, far-reaching -- legislation, we at the Ford Foundation have devoted substantial time and energy to understanding and implementing the provisions that pertain to our work. We have held frequent

staff meetings and have worked closely with our grantees on the applicable provisions. We have prepared internal procedures to ensure our full compliance with the legislation and the Treasury Regulations. We have discussed the effects of the Act on our work in our Annual Reports, in testimony before other committees of Congress, and in other forums. Further, we believe that continuing review of the legislation, of which these hearings are an example, is wise and important so that all of us may be sure it is achieving its goal of safeguarding and promoting the public interest.

We believe that tax provisions relating to charity are intended to encourage the charitable tradition of American society, as it is carried forward by individual citizens and by such institutionalized philanthropy as foundations, hospitals, colleges and universities, and voluntary associations. In our view, the Tax Reform Act has, on the whole, worked well. We believe it helps to preserve and encourage the purposes and the best traditions of American philanthropy.

* * *

The main program restrictions in the Act relating to the work of private foundations concern:

- (a) attempts to influence legislation;
- (b) grants to individuals; and
- (c) "expenditure responsibility" for foundation grants to organizations other than publicly-supported charities.

(a) Attempts to influence legislation

The Act prohibits foundations from attempts to influence legislation. However, it explicitly permits -- and thereby, we believe, implicitly encourages -- foundations to support nonpartisan analysis, study, or research on issues that are or may become the subject of legislative or other governmental action. We were pleased that the Congress specifically recognized such work as well within the scope of legitimate philanthropic activity. Research and analysis supported by various private foundations has contributed importantly to the discussion of ideas and the understanding of significant public issues. Such studies have frequently been employed by Congress, other branches of government, and the public in considering matters of public interest. In short, the ideal of an open society, which thrives on the diversity and multiplicity of views, is embodied in the Act's provisions which permit foundation-supported objective study and analysis, regardless of the subject.

While it is clear to us that Congress has shown its understanding and approval of this function of private foundations, it seems to me to be less clear that the public at large is aware of the nonpartisan role of foundations, along with other American institutions, in the marketplace of ideas. Having demonstrated its awareness of that role and expressed itself in legislation, the Congress is in a position to add to such understanding generally. The establishment of this Subcommittee and the holding of these hearings are certainly steps in the right direction. Those of us in the foundation field believe these hearings will result in a wider awareness of the role of philanthropy in the study and discussion of public issues.

Insofar as the Ford Foundation is concerned, we carefully scrutinize grants for such research to assure ourselves that they fall within the activities permitted by the Act and the Regulations issued under the Act. Happily, the Act permits foundations to support study and discussion of a wide variety of issues, issues of deep public concern, and this the Ford Foundation continues to do. Thus we have in the last four years contributed millions of dollars for research on drug abuse, crime, environmental and energy issues, arms control and disarmament, population policy, and other matters affecting the well-being of the American people -- all subjects of major significance to the citizens of our Country. We hope that foundations will not shy away from support of any activity related to issues that may become the subject of legislative action, either in the mistaken impression that such support is not permissible or in the interests of playing it safe. If they do so, they would be abandoning a constructive means of advancing public knowledge and understanding. I hope these hearings will play a part in preventing that kind of retreat on the part of foundations.

(b) Grants to individuals

Assistance to individuals has a long and honored place in the history of American philanthropy. Scholarships, fellowships, and other forms of encouragement to individual scientists, artists, scholars and others have yielded great benefits to society in all

fields of endeavor. Congress recognized this in the Tax Reform Act, but in order to ensure objectivity and nondiscrimination in this area, the Act and the Regulations have established a new procedural framework for grants to individuals. To comply with these provisions requires a substantial amount of administrative work by foundations and imposes additional requirements on the recipients of individual grants. The additional workload can be handled by a foundation with full-time legal and accounting staff, notwithstanding the costs. But the weight and complexity of the provisions have led some foundations to reduce the number of grants to individuals, and in a few instances I understand that foundations have stopped individual grant-making altogether. If this is so, it is regrettable. Earlier this year, in a talk to the Association of the Bar of the City of New York, I urged that foundations review their understanding of the Act's provisions on grants to individuals. I believe that the difficulties, while administratively formidable even for large foundations, are not insurmountable. Although the costs and complexity of doing so have increased, I am pleased to report that the Ford Foundation continues to make grants to individuals. At the same time, in light of the administrative requirements, I can understand the reluctance of some foundations to make grants to individuals. It is our hope that these hearings will help to clarify what we perceive as the Act's intent to preserve this important mechanism of philanthropy.

(c) Expenditure Responsibility

Much of what I have said about grants to individuals applies as well to grants to organizations that require foundations to exercise expenditure responsibility. Grantor foundations must exercise "expenditure responsibility" with respect to grants to organizations which are not publicly-supported charities. In abbreviated terms expenditure responsibility means that a grantor foundation must establish and follow fairly complex procedures to assure that a grant is spent for the purposes for which made, must obtain complete reports from the grantee on how funds are spent and must make full reports to the IRS with respect to such expenditures.

In most cases where "expenditure responsibility" must be exercised, the requirements are perfectly reasonable. But in cases where grants are small in amount, expenditure responsibility requirements impose a relatively large administrative cost upon both the grantor and the grantee to carry out the reporting and accounting requirements. We, therefore, believe that for grants paid during any taxable year which do not exceed a specified level the grantor foundation should be excused from exercising expenditure responsibility provided, of course, that the grantee organization is organized and operated as a charitable organization. To prevent misuse of this exemption from expenditure responsibility, all grants made by any one grantor to any one grantee organization during the taxable year should be aggregated.

I want also to mention one other difficulty with the provisions of the Act related to "expenditure responsibility". These provisions have created an arbitrary and somewhat harmful distinction among charitable institutions. In some cases the result has been the reclassification as private foundations of organizations whose activities consist almost entirely of study and research and not the making of grants to other organizations.

This reclassification has had serious financial and consequent program effects on such organizations, because some foundations have chosen to avoid the burden of expenditure responsibility simply by eliminating them from consideration as possible grantees. Our own experience is that it is worth the effort of assuming expenditure responsibility in the interest of assisting these organizations' charitable activities. But some foundations have chosen not to, and given the administrative burdens I have referred to, their reluctance is understandable. Yet the net effect is to penalize charitable organizations that need funds badly. For this reason, we believe the Congress may wish at some point to study the practical consequence of the "classification" provisions of the Act.

* * *

I conclude with a brief observation about a provision of the Act outside the category of program restrictions -- the

four percent "excise tax" imposed by the Act on the income of foundations. As Mr. Bundy, President of the Ford Foundation, stated before a House subcommittee earlier this year "...the terms 'audit fee' and 'service charge' far better describe the Congressional interest than the term 'excise tax', and ...it is desirable to reflect this fact in the law." While there may be legitimate grounds for requiring foundations to cover the costs of proper federal regulation of foundations, the experience of the Internal Revenue Service since the Act went into effect is that the proceeds of the excise tax far exceed the costs of auditing. Since the amounts in excess of need reduce the resources available for grants to charitable activities, we believe there should be a reduction in the excise tax, at least to a level commensurate with the costs of regulation.

In conclusion, I believe the Tax Reform Act has not only provided useful rules and guidelines for private philanthropy but has also led to a fuller, more critical -- and constructive -- self-examination on the part of the foundations themselves, and I am pleased that your Committee has provided this opportunity for us to say so.

SENATE FINANCE COMMITTEE

SUBCOMMITTEE ON FOUNDATIONS

Testimony by Dr. Russell G. Mawby
at October 2, 1973 Subcommittee Hearings

SUMMARY OF PERTINENT POINTS

1. The analyses by the Commission on Foundations and Private Philanthropy (The Peterson Commission) which led to the enactment of the 6 per cent distribution rule in Section 4942 of the Internal Revenue Code of 1954 reflected inaccurate information and misrepresentation of the actual situation.

The principal contention reflected in the Peterson Report was that portfolios of private foundations had not produced rates of returns thought to have been produced by mutual funds. This conclusion was based upon a one year analysis and was erroneous in terms of continuing performance.

2. The 6 per cent pay-out requirement enacted by a Senate Floor Amendment and later accepted by the Conference Committee mandates the continuing invasion of corpus by private foundations, an unsound practice in prudent fiscal management.

Studies show that the 6 per cent pay-out rule results in short term increases to charity but that the diminution of assets of private foundations to meet the pay-out requirement is so drastic as to cause long term reductions in their philanthropic distributions for charitable purposes.

3. The Peterson Commission Report also erred in assuming that annual increases in costs in the educational and health sectors of the economy were no different than in the economy generally and its studies were based upon a presumption of an annual cost increase of 2 per cent.

Higher education and the health sectors are labor-intensive service industries where it is difficult to achieve gains in productivity experienced in goods-producing industries. Cost increases in the health and educational sectors greatly exceed those in the economy generally, thus putting pressure on the abilities of foundations to continue to maintain their relative contributions to society.

4. Unless the 6 per cent minimum distribution rule of Section 4942 is reduced the rule will progressively impair the effectiveness of all foundations and even eliminate many of them, to the detriment of society.

If private philanthropy is to continue its historic contribution to American life, changes in the current legislation -- including a reduction in the pay-out requirement -- are necessary.

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON FOUNDATIONS

Testimony by Dr. Russell G. Mawby
at October 2, 1973 Subcommittee Hearings

My name is Russell G. Mawby, and I am President of the W. K. Kellogg Foundation in Battle Creek, Michigan. On April 10 of this year the W. K. Kellogg Foundation testified before the Committee on Ways and Means of the U. S. House of Representatives on the subject of the impact of the minimum distribution rule (Section 4942 of the Internal Revenue Code of 1954) on Foundations. Much of the brief testimony which I give today will parallel the testimony presented at those hearings. My testimony is also supported by a study entitled "The Impact of the Minimum Distribution Rule on Foundations" by Dr. Norman B. Ture. A copy of that study is submitted along with my testimony for incorporation into the record.

Since my testimony is concerned with the minimum distribution rule as enacted by the Tax Reform Act of 1969, my remarks will be restricted to Section 4942 of the Internal Revenue Code. However, I would like it to be known for the record that we share the concern that the 4% excise tax levied under Section 4940 should be eliminated or, in the alternative, reduced to a rate which would equal the audit costs the tax is intended to defray. Similarly, the Kellogg Foundation joins other Foundations concerned over the substantial reductions in assets which have been occasioned by forced diversifications of Foundation holdings, both to meet the arbitrary percentage standard of the 4942 payout requirements and to satisfy the divestiture rules of Section 4943.

Before briefly setting forth the legislative history concerning section 4942, I would remind you of the requirements of the provision; that is, private foundations must make annual distributions in the amount of the greater of either their earned income or a fixed percentage of the current market value of their investment assets.

The rationale behind this concept was to insure that current distributions are sufficient to justify tax benefits donors might have received, and to prevent private foundations from investing in the stock of companies which retain most of their earnings and thereby delay charitable expenditures commensurate with the value of their assets. In order to avoid this delay of benefit to charity, section 4942 requires private foundations to make annual distributions at a prescribed level, even if an invasion of capital may be necessary.

Many find this approach objectionable, not only because it mandates an encroachment on capital, but also because many private foundations that are currently able to support major charitable programs are able to do so only because their assets have been historically invested to provide a reasonable appreciation in value as well as a fair current return. To illustrate this point, the Kellogg Foundation historically has distributed all of its income. Over the years the Foundation's assets have doubled in value every ten years. Most importantly, because of this appreciation, the payout to charity has more than doubled each decade. As I will show later, an annual invasion of principal would have made this record of charitable contributions impossible.

I would emphasize that philosophically I support the concept of a minimum annual charitable distribution. However, I am concerned with the method of determining such a distribution as set forth in section 4942; and even if that method of determination were acceptable, the 6-percent rate should be reduced because it is historically unrealistic.

Moving now to the legislative history, the minimum distribution rule has its origin in the "1965 Treasury Report on Private Foundations" submitted to the House Committee on Ways and Means. That report espoused the theory that there should be a correlation between the immediate tax benefit to foundation donors and the time of foundation grants or benefits to charity. However, it also noted that the income of assets held by foundations should be on a parity with other tax-exempt entities such as colleges and universities. Also, it stated that the retention of capital by foundations is justifiable.

The report concluded that a reasonable income equivalent would be in the range of 3 to 3 1/2 percent. Thus, it is obvious that the report did not intend to require foundations to distribute to charity an amount that would require diminution of corpus as section 4942 clearly requires.

The first hint that the minimum rate proposal as adopted in 1969 might be above the 3- to 3 1/2-percent level appears in former Secretary of the Treasury Fowler's statement to Congress on December 11, 1968, when he used an example which assumed a 5-percent income equivalent. This example was apparently the basis for the Committee on Ways and Means adopting a 5-percent minimum payout. The Senate Finance Committee accepted the 5-percent level recommended by the House committee.

On December 6, 1969, Senator Percy in a floor amendment which was passed, raised the level from 5 percent to 6 percent, which was accepted by the conference committee. Senator Percy explained his action was based mainly on the recommendation of Mr. Peter G. Peterson, Chairman of the Commission on Foundations and Private Philanthropy, who suggested that a proper rate of return for foundations would allow such entities to pay out between 6 and 8 percent annually. Thus, the 6-percent payout requirement represents a 100-percent increase in the minimum initially proposed by the Treasury, and, in addition, it is premised upon and reflects the inaccurate conclusions of the Peterson report. It is interesting to note that, in introducing his floor amendment, Senator Percy further stated that, more important than the particular percentages, are the assumptions on which the percentage should be based: "The payout requirement should be high enough to require them (private foundations) to invest their funds productively. The percentage should not be so high as to amount to a delayed death sentence."

To illustrate our concerns with the payout provision, I will use the experience of the Kellogg Foundation as a representative case. Our founder, W. K. Kellogg, realized a total tax benefit (income, gift, and estate) of approximately \$364,000 on gifts of \$45 million which today have a total fair market value of approximately \$576 million. The total of these assets are maintained on behalf of the Foundation in two separate portfolios, which we refer to as "Kellogg" and "Diversified." The Kellogg portfolio consists entirely of Kellogg Co. stock with a value of \$529 million. The Diversified portfolio consists of stocks, bonds, and other interest-bearing

investments and has an approximate value of \$47 million. Through the years, Kellogg has consistently outperformed the Diversified portfolio which is used to measure the merits of diversification.

A principal contention reflected in the Peterson report was that the portfolios of private foundations had not produced the rate of return thought to have been produced by mutual funds. By any measure of return, the Kellogg Foundation has outproduced mutual funds for the period covered by the Peterson report and has continued to do so since. For example, in the last 7 years the Kellogg Foundation's income, because of holdings in the Kellogg Co., has continued to be substantially greater than it would have been had its income been derived entirely from diversified investments. The increase in income for our 1972 tax year compared to 1966 was 66.5 percent for the Kellogg holding as compared to an increase of 12.8 percent on the foundation's diversified portfolio. It is evident that the sale of Kellogg stock and the diversification of funds would result in a lower return to charity over the years.

Year Ended August 31	Kellogg		Diversified	
	Net Income From Kellogg Stock	% Increase Over 1967	Foundation Income From Other Investments	% Increase Over 1967
1967	\$11,272,650		\$1,852,705	
1968	12,177,062	8.0%	1,954,008	5.4%
1969	14,438,092	28.0	1,834,420	(.9)
1970	14,890,298	32.0	1,831,344	(1.1)
1971	17,606,034	56.1	1,711,651	(7.6)
1972	17,319,265	53.9	1,941,018	4.7
1973	18,775,544	66.5	2,090,946	12.8

Not only was the Peterson report incorrect in regard to performance, but its premise that a pegged payout requirement would be good for charity is also wrong. For example, had the minimum distribution rule been in effect

at 6 percent from 1934, when the trust consisted of 221,000 shares of Kellogg stock, with a then market value of \$38 million, the following would have occurred:

1. From 1934 through 1972, the trust made an actual distribution of \$222 million. Had the minimum distribution rule been applicable, distributions of \$259 million (or an increase of \$37 million) would have been made;
2. To meet that payout requirement, the trust would have had to sell the equivalent of 18 million shares with a market value of \$265 million; therefore, the trust's holding would have been reduced to a market value of \$265 million; and thus
3. The short-term higher return to charity of \$37 million would have cost \$265 million in corpus value, thereby reducing the current size of the trust by 50 percent. Further, for 1973-74, the distribution from the reduced assets would have been only \$10 million rather than the \$20 million which will in fact be distributed.

With 3 years of experience under the 1969 law, there has been time to examine how section 4942 will operate to undermine overall foundation grants, and there has been the opportunity to further examine the assumptions of the Peterson report. For this purpose, seven Foundations* commissioned a study by Dr. Norman B. Ture entitled "The Impact of the Minimum Distribution Rule on Foundations". This is the study to which I referred in my introductory

*The Hormel Foundation, the Kellogg Foundation, the Kresge Foundation, the Lilly Foundation, the McClellan Foundation, the Pew Memorial Trust, and the Woodruff Foundation.

remarks. The findings and conclusions of that study, as briefly summarized in its own language are as follows:

First, any minimum distribution rule which ignores the foundation's rate of return will have a highly differential, discriminatory and possibly capricious impact on foundations and on their long-term capacity to support charities.

Second, the (Peterson Commission) contention that the investment performance of foundations is relatively poor is based on inadequate information and inappropriate statistical measure; the records of foundations for which data was available in the preparation of this (Ture) report certainly do not support this contention.

Third, no sound evidence was advanced (by the Peterson Commission) to support the view that the allegedly poor investment performance of foundations is related to the concentration of their investment assets.

Fourth, it is neither realistic nor reasonable to assume that a minimum distribution rule will result in significant increases in the rate of return on foundation investments.

Finally, the (Ture) report concludes that the tax savings allegedly realized by those establishing foundations are, in all likelihood, very small. Foundation distributions to charity have represented a sizeable amount of benefits relative to the foregone tax revenues.

Finally, The Peterson Report assumed that the charitable services which a foundation normally supports will not rise in cost any faster than the

general rate of inflation and for that purpose assumed a rate of inflation of 2 percent. The report's assumption is wrong, for it completely disregards the fact that the organizations supported by foundations have little possibility of significant gains in productivity.

Let me cite a few quick examples.

Higher education is a labor-intensive service sector of the economy in which it is difficult to achieve the gains in productivity that are experienced in goods-producing industries. Educational costs per credit hour consistently rose more rapidly than the consumer price index from 1953-54 to 1966-67. Over the period as a whole, educational costs rose at an annual average rate of 3.5%, as compared with a rate of 1.6% for the consumer price index--a difference of 1.9%.¹

The most noticeable feature of the budgets of all institutions of higher education is how fast they have gone up in the years since World War II. Total educational and general expenditures on current account by all institutions of higher education went up from less than \$1 billion in 1945-46 to more than \$7 billion in 1963-64. Total educational and general expenditures less expenditures on organized research have gone up, on the average, more than 7% a year at all private universities. The direct instructional cost per student over the period 1955-56 works out to an average annual rate of increase of 8.3% for all private universities.²

¹ Source: "The More Effective Use of Resources--An Imperative for Higher Education," A Report and Recommendations by the Carnegie Commission on Higher Education, June 1972, pp. 33-38.

² Source: "Economic Pressures on the Major Private Universities," William G. Bowen, Reprinted from "The Economics and Financing of Higher Education in the United States," a Compendium of Papers Submitted to the Joint Economic Committee, Congress of the U.S., Government Printing Office, 1969, pp.399-439.

In the period 1958-71, the average operating budget for medical schools increased from \$2,056,000 to \$8,475,000, an increase of 412%. The mean salary for basic science faculty and for all ranks of clinical science faculty increased 59% and 66% respectively.³

A major program concern and site of W. K. Kellogg Foundation expenditures has been the hospital field. The Foundation has assisted a wide variety of programs in community hospitals such as in recent support for coronary care units and the improvement of burn patient care facilities and services.

The increase of such support by the Foundation has substantially paralleled the general rise of medical care and hospital costs in the United States. Such costs have risen at an annual rate of 11.8% between the years 1950-1970 and the expenses per patient day during the same period rose at an annual rate of 8.6%.⁴

In conclusion, from the foregoing these things are apparent:

1. The analysis which led to enactment of the 6% distribution rule reflected inaccurate information and misinterpretation of the actual situation.
2. The 6% payout requirement mandates the continuing invasion of corpus by private foundations, an unsound practice in prudent fiscal management.

³ Bradford, Malt and Oates, "The Rising Cost of Local Public Services," National Tax Journal.

⁴ Source: Hospitals, J.A.H.A.

3. Cost increases in the charitable services supported by foundations exceed the general inflationary rise, thus putting pressure on foundation ability to continue to maintain their relative contribution to society.

Unless the 6% minimum distribution rule is reduced, it is clear that the principles set forth in the Peterson Report and incorporated in Section 4942 will progressively impair the effectiveness of all foundations and even eliminate many of them, to the detriment of society.

If private philanthropy is to continue its historic contribution to American life, changes in the current legislation--including a reduction in the payout requirement--are necessary. We urge your adoption of such modifications to insure that our society will continue to benefit from the constructive activities of private foundations.

Thank you.

**THE IMPACT OF THE MINIMUM DISTRIBUTION
RULE ON FOUNDATIONS**

by

**Norman B. Ture, Inc.
1100 Connecticut Avenue, N.W.
Washington, D.C. 20036**

April 5, 1973

Acknowledgements

This report on The Impact of the Minimum Distribution Rule on Foundations was commissioned by the Ad Hoc Committee on Section 4942 to provide an objective analysis and evaluation of Section 4942 of the Internal Revenue Code. The report is focused on the impact of the 6 percent minimum distribution rule with respect to foundations' investment performance and their capacity to provide financial support for charities.

Throughout the preparation of this report, I have enjoyed the complete cooperation of the Ad Hoc member foundations in providing me data and other assistance. The member foundations are: Maclellan Foundation, Maclellan Trust, Lettie Pate Evans Foundation, Lettie Pate Whitehead Foundation, Joseph B. Whitehead Foundation, W.K. Kellogg Foundation, Pew Memorial Trust, Lilly Endowment, Kresge Foundation, Emily and Ernest Woodruff Foundation, and Hormel Foundation. (In the interests of preserving confidentiality, the data pertaining to these foundations are identified in this report by code letter in an order which does not coincide with the sequence shown here.) At no time, however, have the foundations or their representatives attempted to influence the substance of or the methodology used in preparing the report. The analysis, findings, and conclusions are those of Norman B. Ture, Inc.

I am deeply grateful for the expert assistance provided me by Mr. Kenneth D. Simonson and others of the staff of Norman B. Ture, Inc.

Norman B. Ture, President
Norman B. Ture, Inc.

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THE IMPACT OF THE MINIMUM DISTRIBUTION
RULE ON FOUNDATIONSI. Introduction

Section 4942 of the Internal Revenue Code requires tax-exempt foundations to distribute to qualified organizations amounts equal to or greater than 6% of the market value of the foundation's assets. This requirement was enacted in the Tax Reform Act of 1969' ostensibly for the purpose of removing the uncertainties and vagaries of prior law under which foundations accumulating income in unreasonable amount or over an unreasonably long period might lose their tax-exempt status. This loss of tax-exemption was thought to be an inadequate threat to avert unreasonable accumulations in some cases and an excessively severe penalty in others. In addition, if a foundation invests in assets that generate no current income flow to the foundation, the unreasonable accumulation rule was, obviously, inoperative. In such cases, it was alleged that the donor of the foundation's assets might receive substantial tax benefits from his contribution, while charities might receive no current benefits, i.e., grants, from the foundations.

During the legislative development of those provisions of the Tax Reform Act bearing on foundations, a large number of issues pertaining to foundations, their role in the U.S. society, and their operations were raised. The focus of legislative deliberations was on efforts to correct alleged abuses by foundations and to circumscribe modes of operation deemed to be inconsonant with the public policy objectives sought in the tax exemption of these organizations.

Insofar as a minimum distribution rule is involved, the principal issue was whether the amount of distributions by foundations to charities was a sufficiently high return on the tax savings afforded those establishing the foundations. To this point, the matters that were raised during the hearings and in floor debate included the contentions that (a) the investment performance of foundations, i.e., the rate of return they realize on their assets, compares unfavorably with that of mutual funds; (b) in some, perhaps considerable part, this poor performance is attributable to undue concentration by a foundation of its assets in a single class of stocks of a single corporation; (c) in many cases, this investment policy by the foundation revealed that its real purpose was to afford continuing family control over the corporation rather than to provide financial support for charitable activities; (d) better investment performance would significantly augment the amount of distributions by foundations to charities; (e) better investment performance called for both more highly diversified and higher yield portfolios, and (f) imposing some relatively high minimum distribution requirement on foundations would effectively impel them to improve investment performance by diversifying their portfolios and increasing their yield, which by the same token would require them to relinquish concentration of asset holdings in a single class of stock in a single company, and which would result in their increasing their distributions to charity.

This report subjects those considerations advanced in favor of a minimum distribution rule to critical examination, both factual and analytical.

Clearly, the fundamental objective of any minimum distribution rule is to increase the amount of private financial support for charitable organizations and their activities. Whether such a rule would achieve any of the other objectives attributed to it is a secondary matter, if not indeed irrelevant.

The findings and conclusions of this report may be briefly summarized. First, any minimum distribution rule which ignores the foundation's rate of return will have a highly differential discriminatory and possibly capricious impact on foundations and on their long-term capacity to support charities. Second, the contention that the investment performance of foundations is relatively poor is based on inadequate information and inappropriate statistical measures; the record of the foundations for which data were available in the preparation of this report certainly does not support this contention. Third, no sound evidence was advanced to support the view that the allegedly poor investment performance of foundations is related to the concentration of their investment assets. Fourth, it is neither realistic nor reasonable to assume that a minimum distribution rule will result in significant increases in the rate of return on foundation investments. Fifth, an appropriate distribution rule should be based on the rate of increase in the amount of distributions desired by public policy, adjusted in the case of each foundation by the rate of return that foundation realizes on its investment.

Finally, the report concludes that the tax savings allegedly realized by those establishing foundations are, in all likelihood, very small. Foundation distributions to charity have represented a sizeable amount of benefits relative to the foregone revenues.

II. Portfolio Investment Policies of Foundations

One of the principal arguments advanced in 1969 in favor of some minimum distribution rule was that, relative to their total assets, foundations generally ". . . are not providing an adequate payout to society in return for the immediate tax deductions society has given their donors."¹ In turn, the allegedly too low distribution rate was related to an allegedly poor investment performance by foundations compared with that of mutual funds. While avowing that it had not exhaustively reviewed the investment performance of foundations (a caution neglected in the 1969 legislative discussions which relied heavily on its data), the Commission nevertheless asserted that ". . . the investment performance of foundations is below par, and perhaps significantly so. . . . Since each percentage point of added total return on foundation investments would yield between two and three hundred million dollars of additional funds for charity, the cost to society of a lackluster management of these investments could be on the order of hundreds of millions of dollars annually."²

The issues raised in the Report and in the 1969 legislative discussions, although separately identifiable, are obviously interrelated. On the one hand, there is the issue of the type of assets held by foundations and of the

1. Commission on Foundations and Private Philanthropy, Foundations, Private Giving, and Public Policy, University of Chicago Press (Chicago), 1970, p. 76. The Commission and the report are referred to hereafter as "the Commission" and "Report," respectively.

2. Report, p. 75. The implications of the quoted statement are examined at a later point in this report.

yield per dollar of such assets, measured against some relevant performance standard. On the other hand, there is the issue of the disposition of the annual return on foundation assets, i.e., the allocation of that return between current year distribution to charities and augmentation of the foundations' future capacity to support charities.

Evaluation of the management of foundation investments is not merely a question of comparing the rate of return on foundation assets with that realized by other investors, say mutual funds. That evaluation must also include an assessment of the long-term objectives of foundations in support of charitable, educational, scientific, medical, etc., activities and of the overall portfolio and grant policies in the light of those objectives.

A. Return on Foundation Assets.

Testifying on October 22, 1969, before the Senate Finance Committee on H.R. 13270, Mr. Peter G. Peterson, then Chairman of the Commission, reported that one of the Commission's findings was that the total rate of return on foundation assets was materially lower than that of mutual funds. The total rate of return, asserted to be the performance yardstick commonly used by mutual funds, profit sharing and pension funds was defined as the sum of dividends, interest, realized and unrealized capital gains divided by the market value of the assets.¹

Using this measure, the Commission's findings, based on a sample of foundations' forms 990A for the year 1968, are summarized in the following table:

1. Cf. Report, p. 74.

Total Return on Foundation Assets as Percentage
of Assets, 1968¹

<u>Foundations with Assets</u>	<u>Median Total Return on Assets (%)</u>
under \$200,000	4.7
\$200,000-\$1,000,000	6.7
\$1,000,000-\$10,000,000	6.0
\$10,000,000-\$100,000,000	7.7
over \$100,000,000	8.5
Company foundations	5.8
Community foundations	5.2
Weighted figure for all foundations	5.6

By contrast, the Commission found an annual average total return for the years 1959-68 for 21 balanced funds of 9.2 percent and for 10 large general growth funds of 14.6 percent. For 1968, the Commission cited an average total return of 15.3 percent for common stock mutual funds and of 14.9 percent for balanced funds.²

A number of aspects of these "findings" cast serious doubt on their interpretability and reliability. First, the percentages reported are median values, not weighted arithmetic means or averages. The Commission explained the use of the median figure as intended to help offset any disproportionate effects of those foundations which did not report assets at market value. For reasons explained below, any such foundations should have been eliminated from the calculation. Use of the median rather than mean does not

1. Report, p. 74.

2. Ibid.

bear on the bias introduced by the inclusion of data from such foundations. The median measure reported by the Commission for each size class identifies the total rate of return of that foundation with respect to which there were an equal number of foundations with a lower and a higher rate of return. But this measure does not tell one how the foundations in that size class, taken together, performed. For example, suppose a size class consisted of 5 foundations each with \$1 million of assets, one of which had a zero total rate of return (as measured by the Commission), one had returns of \$10,000 or 1 percent, one had returns of \$20,000--2 percent--and two had returns of \$200,000 each--20 percent. The median return "found" by the Commission would be 2 percent, although taken as a group, the five foundations had total returns of \$430,000 on \$5,000,000 of assets, or an average return of 8.6 percent.

In addition, the Commission apparently compared its median rate of return with a weighted mean--or average--return for the unidentified mutual funds to which the Report alludes. Suppose that the distribution of mutual funds by rate of return was identical with the distribution of foundations in the illustration above. Then comparing the median value of foundation rate of return with the mean value of mutual fund rate of return would come up with the "finding" that the mutuals had outperformed the foundations by 4.3 to 1, despite the fact that their respective performances were by hypothesis identical.

Moreover, as noted above, the inclusion of results based on book values for some foundations with market values for other foundations puts the

"findings" of median rate of return quite beyond interpretation or analysis. Referring to the Commission's definition of total returns--the sum of dividends, interest, realized and unrealized capital gains--consider a foundation whose assets are reported per book rather than market values. Suppose the market value of the foundation's assets increase by, say, 15 percent from the beginning to the end of the year, because the corporation whose stock constitutes the assets of the foundation has retained the full amount of its earnings. The appreciation in the market value of the stock of course reflects the market's capitalization of the increase in the corporation's future earnings which will flow from the retained earnings of the current year. But this market appreciation will not necessarily be fully or even substantially reflected in the book value of the stock held by the foundation. The computed total return on assets, relying on book values, may therefore fall materially short of that which would result from using market values. Including measures of total rate of return based on book values, therefore, is highly likely to bias the Commission's findings downward from the actual total rate of return of the foundations. Moreover, it invalidates any comparison with the total rates of return realized by other institutional investors.

Finally, the Commission's "finding" that the investment performance of foundations is below par is based on the results of a single year's operation by the sampled foundations. The Report conceded that one year is not an ade-

1. In fact, some of the foundations in the Commission sample reported no change in book value of assets on their Forms 990-A, although the market value of their assets rose significantly. While it is conceivable that book values might increase more than market values, this is far less likely to occur.

quate period for evaluating investment return;¹ nevertheless, this perfectly correct caution did not preclude the Commission from making a comparison of investment performance and from concluding on the basis of that comparison that foundation management of their portfolios was lackluster.

In contrast with the Commission's findings, which were the principal data source for legislative discussions in 1969, examination of the investment performance of several major foundations leads to the conclusion that these foundations were highly efficient in their investment management, at least as measured by the Commission's total rate of return. For foundations, the annual average rate of return from the time of first endowment through 1972 ranged from a low of 12.3 percent to a high of 21.5 percent.² For some of these foundations, to be sure, considerable fluctuations in total rate of return from year to year were experienced, but even so, the rate of return record of each over its lifetime has been impressive. Thus, the average annual total return, including dividends and appreciation in the market value of assets, computed as the compound interest rate of growth from the year of initial endowment through 1972, ranged from a low of 7.9 percent to a high of 17.2 percent.

1. Report, p. 74.

2. Average, for each foundation, of the total rates of return for each year from initial endowment through 1972.

<u>Foundation and year of endowment</u>	<u>Average annual total rate of return</u>	<u>Compound interest average annual rate of increment over market value of initial endowment*</u>
A (1958)	13.3%	13.1%
B (1957)	12.3	12.0
C (1945)	14.6	9.0
D (1954)	21.5	17.2
E (1940)	15.1	9.7
F (1935)	13.9	7.9
G (1939)	14.5	9.0
H (1924)	14.9	9.1
I (1955)	16.7	10.6
J (1948)	10.0	8.0
K (1938)	14.0	16.9**

* Adjusted for additional contributions and stock splits

** Since 1952

There are, in short, substantial grounds for skepticism about the Commission's "findings" of poor investment performance by foundations. It is regrettable that these "findings" and the conclusion drawn by the Commission from them were not subject to more critical examination in the legislative development of the Tax Reform Act of 1969.

B. The Appropriate Measure of Return for Foundation Distributions

The minimum distribution rule of Section 4942 relates the required distribution by a foundation to the average market value of its assets. In this respect, the rule follows the reasoning advanced by the Commission

with regard to the measure of the base against which foundation distributions should be evaluated.¹

For purposes of the investment policies of households and businesses, choice among investment property depends on the potential gain in net worth afforded by the investment alternatives open to the investor. This gain in net worth is the sum of current income flows from the investment and appreciation in the market value of the investment assets. Thus, for purposes of evaluating the investment performance, the measure cited by the Commission is appropriate.

It does not follow, however, that gain in net worth as measured in the market place over given time period affords an appropriate basis for rules governing distribution policies.

Consider the case of a corporation with earnings in a particular year of, say, \$1,000,000, where its earnings are measured according to the provision of the Internal Revenue Code and Regulations. In general, earnings so measured will be equal to receipts from the company's operations less expenses. Earnings do not include the appreciation in the market value of the corporation's equity. Nor should they. If these unrealized capital gains were included in income for the year, gross double counting would result, since the capital gains are, for the most part, the market's capitalization of the increase in the company's future income.

Suppose the corporation retains the full amount of its earnings for that

1. Report, p. 74.

year. These retained earnings, prudently and effectively invested by the corporation, will produce an increase in the company's future income. The valuation in the market place to that additional future income will be reflected in an increase in the market value of the company's equity. But the unrealized capital gain can hardly be regarded as part of the company's income for that year.

For purposes of the accumulated earnings tax (Section 531-537), this retention of earnings may be deemed to represent an improper accumulation, and an additional tax may be imposed. But the accumulated taxable income on which the additional tax may be imposed is determined by reference to the corporation's taxable income (with certain adjustments), which does not include the company's unrealized capital gains, i.e., the increase in the market value of its equity.

The shareholders of this company will enjoy unrealized capital gains, assuming that they retain their stockholdings and the market value of their shares increases in some proportion to the company's retained earnings. These unrealized capital gains, however, are not included in the income of the stockholders, nor should they be, even though the appreciation in the market value of their shares increases their net worth. To include this appreciation in the shareholders' current year's taxable income would be to subject them to tax on the capitalized value of future income as well as on the future income itself as materializes over time.

A foundation as one of the shareholders of the corporation no more than any other shareholder realizes income by virtue of the increase in the

market value of its shares of the corporation's stocks. For effective management of its operations, the foundation must be constrained by the income it receives on its assets, not by the increase in the market value of these assets. The imposition of rules, pertaining to its operations, which rely on changes in the market value of the foundation's assets, thus, subjects the foundation to constraints dissimilar from and far harsher than any others applied by the Internal Revenue Code to any other class of entities.

For the reasons presented below, any uniform minimum distribution rule is likely to be at odds with public policy objectives concerning foundations and their financial support of charities. Apart from these considerations, a minimum distribution rule which relates required foundation distributions to the market value of foundation assets rather than to foundation income will almost certainly produce highly anomalous and disparate results among foundations.

The obvious case in point involves differences among foundations with respect to the liquidity of their assets and the current income flow these assets produce. Thus, a foundation with a substantial proportion of its assets in, say, a low payout, growth corporation may very well be required under the minimum distribution rule, to liquidate significant amounts of its assets, while another foundation with a substantial part of its assets in high payout, low yield shares in a slower growing company may be under no such constraint. In terms of investment performance and growth in capacity to provide financial support to charities, the first foundation may very well be highly superior to the second. The impact of the minimum distribution

rule, however, is precisely contrary to the objectives articulated for it in this case. Indeed, if the first foundation's stock is that of a closely-held company for which little or no market exists, the foundation may be put into an impossible position with regard to both effective management of its investments and building the capacity to support charity.

Similar difficulties will arise where substantial amounts of the foundation's assets are in real estate on which the net cash flow is less than 6 percent of the market value of the property. The investment in this property may very well be superior to any alternative available to the foundation in terms of the Commission's total rate of return as well as in terms of building capacity for distribution to charities. Yet the minimum distribution rule might very well require the foundation to liquidate these assets and either to replace them with others which are inferior or to reduce permanently their capacity to support charity.

There is, as one might expect, substantial variation among foundations in their investment policies and asset composition. The minimum distribution rules of Section 4942 make no adequate allowance for these variations. The impact of Section 4942, therefore, is likely to be highly discriminatory. Moreover, since these differences in effects are not necessarily, if at all, in line with public policy objectives, the minimum distribution rule is likely to be highly capricious.

If some minimum distribution rule, imposed at a uniform rate on all foundations, is to be continued, it should be applied with respect to foundation income, not foundation assets.

C. Investment Performance and Portfolio Concentration

One of the explanations offered for the allegedly poor investment performance of foundations, according to the Commission, is that "... a significant portion of a foundation investment portfolio is often control stock in a company."¹ Regrettably, the Commission provided no data showing the number or proportion of foundations whose portfolios were highly concentrated nor did it attempt to correlate foundations' rate of return experience with the degree of portfolio concentration.

The Commission did, however, provide some data, drawn from its 1968 sample of foundations, bearing on the distribution of foundation assets by type of asset. Excluding the Ford Foundation, the Commission found that stock in a company in which a donor and his family owned a controlling interest (20 percent or more of the total issued) constituted 30 percent of total foundation assets. Appreciated real property was 4 percent of the total, other appreciated intangible property was 36 percent, while cash or unappreciated property was 25 percent. The proportions differed somewhat depending on the foundation size class; for foundations with over \$100 million of assets (excluding the Ford Foundation) control stock was 56 percent of total assets, compared with 19 percent for foundations with total assets less than \$200,000. Moreover, the Commission found, only 14 percent of the sampled foundations had received half or more of their contributions in control stock.²

1. Report, p. 75.

2. Report, Tables A31-33, pp. 243-245.

The view that the allegedly poor investment performance of foundations results from the lack of adequate portfolio diversification is without substantiation. Appropriate data, if available, might indeed reveal a correlation between rate of return and degrees of diversification, but as matters stand, such correlation is pure conjecture.

Quite a different surmise emerges from examination of the investment performance of the foundations shown in the table above. In each case, the foundation's assets are highly concentrated in a single class of stock. The wide range of average rates of return among these foundations argues strongly that, at least in their case, rate of return is not correlated with portfolio diversity.

Some significant degree of portfolio diversification may be a valid general prescription for balancing yield and risk. It does not follow, however, that the diversification appropriate for one investor is equally appropriate for any other. Diversification per se is not an investment objective to be blindly or slavishly pursued in disregard of the rate of return experience of existing portfolios. Changing portfolio composition entails the costs of acquiring information on other investment assets and, generally, some transaction costs. It is by no means clear that any of the foundations shown in the table above could reasonably expect by diversifying their portfolios to improve their investment performance sufficiently to warrant incurring the costs such diversifying would require.

D. Distribution Policy and Rate of Return.

More fundamentally, the relevance of foundation investment performance to the desirability of a minimum distribution rule is obscure. Surely the occasion for a minimum distribution rule is not to improve foundations' investment management, in and of itself. A tax provision aimed at such a result for foundations would be highly discriminatory, since no other provision of the Internal Revenue Code bearing on any other class of entities is endowed with a similar intent. The purpose of a minimum distribution rule, rather, is to increase the amount of foundations' distributions to charities. Any such increase currently or in the near future will occur at the expense of less capacity by foundations than they otherwise would have to provide such support over the longer term unless foundations are able sufficiently to increase the rates of return on their investments. If it is desired to increase distributions currently or in the near-term and if the amount of the increase in distributions is relatively large, a minimum distribution rule designed to achieve this result will require large-scale inroads on the existing assets of foundations, the effects of which on future total returns and distribution capacity will far outweigh any increase in rate of return that might be realized by changes in foundation portfolios.

To the extent that public policy calls for a continuing and growing distribution capacity by foundations over the long term, a minimum distribution rule is counterproductive, irrespective of the total rate of return on foundation assets. The higher the required minimum distribution rate, the

greater the likelihood of required reduction in foundation corpus, the effect of which on long-term distribution capacity is likely to outweigh by far any increase in rate of return which may be realized by changing the composition of the remaining corpus.

This may be illustrated by a hypothetical example. Suppose a foundation's initial endowment was \$1,000,000, which was invested at an annual interest rate of, say, 15 percent, and suppose the foundation's annual distributions were 1 percent of its assets. At the end of 10 years, it would have distributed a total of \$386,800, roughly, and would have accumulated total assets, i.e., distribution capacity, of about \$3,658,750. If the foundation had been required to distribute each year 5 percent of its accumulated principal at the end of each year, the accumulated principal at the end of 10 years would be about \$2,482,240, about \$1,236,510 less. Distributions of \$1,623,310 during the first 10 years instead of \$386,800 would reduce distribution capacity over the succeeding 10 years by about \$5,002,400 or by roughly 4 times the additional distributions in the first 10 years. In order to distribute each year 5 percent of the accumulated principal at the end of each year and to achieve the same distribution capacity at the end of 10 years as if annual distributions were 1 percent of assets, the initial principal would have to be invested at an interest rate of 19.84 percent, 32.3 percent greater than the assumed actual rate of 15 percent.

With a 6 percent minimum distribution rule, distributions totaling \$1,866,560 would be required in the first 10 years, resulting in accumulated

assets of about \$2,179,000 at the end of 10 years. Distribution capacity for the succeeding 10 years would be reduced by roughly \$7,550,000. To avert this loss in distribution capacity, the initial endowment would have had to have been invested at a rate of return of 21.1 percent, about 41 percent more than the assumed actual rate of 15 percent.

If the foundation's rate of return were 10 percent, instead of 15 percent, requiring it to increase its distribution rate from 1 percent to 5 percent would result in additional distributions of \$792,760 over the first 10 years, but would reduce the accumulated distribution capacity over the next 10 years by \$1,860,000, roughly. A 6 percent minimum distribution rule would require \$948,700 in additional distributions in the first 10 years but would reduce distribution capacity in the succeeding 10 years by about \$2,225,000. To avert this loss in distribution capacity, the rate of return on the foundation's assets would have to increase to 14.6 percent and 15.85 percent, or by 46 percent and 58.5 percent, respectively.

Quite clearly, increases in rates of return of these magnitudes are hardly likely to be attained by even the most active and speculative investment management. Any minimum distribution rule which in practice requires foundations to increase the rate of their payouts to charities cannot realistically be justified as intended to improve the investment performance of foundations. On the contrary, the justification for any such rule must be the value judgment that the benefits from an increase in current distributions outweigh the costs of the reduced distribution capacity for the longer term.

E. Distribution Policy Criteria

For the long term, an appropriate distribution rate for any foundation must depend both on the desired rate of increase in its distributions and on the rate of growth of its distribution capacity, as well. Unless a fixed time horizon is placed on charities' requirements for financial support, or unless it is desired to substitute government financial support for private sources, the distribution rate required of foundations must take into account the impact of current and near term distributions on the capacity of foundations to provide the desired distribution in any future year. The higher the desired rate of growth in distributions relative to the rate of growth of assets, the lower must be the annual distribution rate if the foundation is to be able to meet its long term commitments.

The present 6 percent minimum distribution rule obviously does not take these considerations into account. For a great many foundations, it will require a sharp deceleration in the growth of their distributions. And for any foundation with a rate of return less than 6.5 percent, it will result in reduction and eventual exhaustion of assets and an absolute decline in the amount of distributions.

The following table shows the maximum rate of growth in the amount of foundation distributions, given alternative rates of return, under the 6 percent minimum distribution rule. For any foundation

<u>Rate of Return</u>	<u>Maximum Rate of Growth in Amount Distributed</u>
7.5%	1.05%
10.0	3.40
11.7	5.00
12.5	5.75
15.0	8.10

with a rate of return of, say, 10 percent whose distributions to charity have been growing at a rate faster than 3.4 percent, the 6 percent minimum distribution rule will require a cut back in the rate of expansion of distributions. Moreover, this cut back in the rate of growth of distributions is not a hypothetical matter. Every one of the foundations shown in the table below will be required to slow the increase in its distributions as a result of the 6 percent minimum distribution rule. In most cases, the required reduction in the rate of growth will be substantial.

<u>Foundation</u>	<u>Actual Rate of Growth of Distributions</u>	<u>Percent Reduction in Rate of Growth of Distributions</u>
A	15.7	59.9
B	14.9	64.2
C	9.9	71.7
D	12.9	20.9
E	7.6	59.2
F	2.8	50.0
G	16.5	84.8
H	10.4	75.0
J	7.2	79.2
K	11.4	13.2

In all but two cases, the 6 percent minimum distribution rule will result in reductions in the distribution growth rate of well over 50 percent. In fact, the smallest reduction is 21 percent.

For all foundations, the average annual rate of increase in distributions to charities over the years 1955 - 1971 was about 10.2 percent.¹ The 6 percent minimum distribution rule, applied across the board, may very well reduce this growth rate to 5 to 6 percent.

These consequences of the 6 percent minimum distribution rule clearly are grossly at odds with the ostensible objective of the rule, viz., to impel foundations to accelerate the growth in their distributions. There is a broad consensus that the needs of charities for private financial support are expanding at an accelerating rate,² clearly implying that the desired growth rate of foundation distributions to charities over the next decade and a half should exceed that of the decade and a half from the mid - 1950's. And indeed, it must be this persuasion that is the basis for the public policy position that foundations should increase their distributions to their recipient charities. But the minimum distribution rules of Section 4942, as demonstrated, are contraproductive to this end, when account is taken of the facts of foundations' distributions and earnings.

Any uniformly applicable minimum distribution rule, therefore, will

1. Statistical Abstract of the United States, 1972, Table No. 499, p. 306, from American Association of Fund Raising Counsel, Inc., Giving U.S.A.

2. Cf. Report, Chapter 3 and Appendix II, 1.

discriminate severely among foundations, not in line with objectives of public policy but on the basis of factors over which public policy has little control. As shown above, these discriminatory effects of a minimum distribution rule cannot reasonably or realistically be justified as impelling foundations to manage their investments more efficiently.

F. Investment Performance and Distributions

The Commission contended that improved investment performance by foundations would result in increases in distributions to charities,¹ and this assumption was repeatedly articulated during the legislative hearings and debates. A minimum distribution rule, as already noted, was widely viewed as impelling foundations to improve their investment performance. Presumably, any increase in investment returns resulting from this improvement would be immediately passed on in additional distributions to charities. To complete the syllogism, by requiring foundations to improve their investment performance, a minimum distribution rule would result in additional distributions to charity.

Interestingly enough, this line of reasoning is the reverse of the justification for a minimum distribution rule based on the view that foundations were not distributing enough of their earnings. The clear implication of the latter view is that given their rate of return, foundations could well afford to increase their distributions.²

1. Report, p. 75

2. Congressional Record, December 6, 1969, pp. S 15959 - 15963.

The Commission's reasoning and much of the legislative discussion appears to be excessively mechanistic, ignoring a host of considerations which enter into foundations' determinations of the amount of their distributions. In the first place, as the discussion above demonstrates, full distribution of any increase in earnings resulting from an increase in rate of return would not conform with the condition that the foundation should be able to meet any future, targeted distribution. Beyond this observation, however, foundation distribution policy is also guided by considerations of the specific charitable activities which the foundation wants to support, the present demands of such charities relative to those which may be reasonably anticipated at a future date, the capacity of the donee effectively to utilize additional grants currently compared with their use at a later date, and so on. The balance among these and numerous other considerations dictate efficient distribution policy.

To be sure, the foundation's rate of return sets a limit on distributions, at least over a period of years. But it certainly does not follow that an increase in rate of return either would or should be promptly reflected in an equal increase in distributions. Moreover, if account is taken of the variability in investment return experience, on the one hand, and of the much steadier increase in charities' demands for financial support over the long term, and the extended time period of many grants, on the other, prompt year-to-year change in response to changes in rate of return would be neither practicable nor desirable.

Over the long term, increases in foundations' rates of return should be expected to result in increases in distributions, based on extrapolation of historical experience. But this historical relationship does not afford the basis for contending that a minimum distribution rule of the sort now in the law will impel an increase in distributions over the long term by virtue of an improvement in foundations' investment performance.

III. Foundation Distributions and Donor Tax Savings

As noted above (section II), one of the major inputs into the 1969 revisions of the tax provisions pertaining to foundations appeared to be the view summarized by the Commission in its assertion that "...foundations ... clearly are not providing an adequate payout to society in return for the immediate tax deductions society has given their donors."¹ At issue is (1) the magnitude of the revenue loss sustained by the Treasury by virtue of the deduction of donors' contributions to foundations and by virtue of foundation tax "exemption", and (2) the comparison of returns which might be expected from the Government's use of the foregone revenue with the foundations' distributions to charities.

Clearly, if it were shown that the magnitude of the tax savings from the deductibility of contributions to foundations is small, or if given the amount of savings it could be shown that the aggregate flow of benefits from the Government's use of the foregone revenue was exceeded by the amount of foundation distributions, the view that foundation payments were inadequate to justify the tax "benefits" would be unwarranted.

A. Amount of Tax Benefits

Net tax savings to donors, hence revenue losses to the Treasury resulting from the income, estate, and gift tax deductibility of

1. Report, p. 76.

contributions to foundations are in all likelihood quite small in magnitude. Close estimation of these tax savings is not feasible, primarily because of the inadequacy of data pertaining to such contributions. It is hardly surprising, in view of these difficulties, that the Commission did not support the quoted statement with a comparison of foundation payout with their donors' tax savings.

According to the Commission, the market value of foundation assets in 1968 was between \$20 billion and \$30 billion.¹ If one were to assume that the average age of the foundations in 1968 was, say, 15 years, and that the average rate of increase in the market value of foundation assets has been, say, 7 per cent, then the value of the foundations' assets at the time they were contributed to the foundations would have been between roughly \$7.25 billion and \$10.88 billion. The tax benefits resulting from these contributions, of course, would have varied substantially, depending on when they were made, the tax deduction allowed at the time, and the applicable tax rate. But suppose that on the average, the contributions had been fully deductible and at a tax rate of, say 50 per cent. Then the tax savings to the donors and the revenue loss to the Treasury would have been of the order of \$3.6 billion to \$5.4 billion.

Alternatively assume that the average age of foundations in 1968

1. Report, p. 151.

was, say, 25 years and that the average rate of growth in the market value of the assets was, say, 15 per cent. On these assumptions, the value of the assets at the time they were donated to the foundations would have been between roughly \$600 million and \$900 million. With an assumed marginal tax rate of 50 per cent, the deductibility of these donations provided tax savings of between \$300 million and \$450 million.

Given the wide range of the estimated age and rate of growth of the assets of foundations and the lack of data pertaining to donor's tax situations at the time of donations, any estimates of the actual amount of the tax savings is subject to an extremely large margin of error. Merely for illustrative purposes, however, assume that the tax benefits, hence Treasury revenue loss, were of the order of magnitude of \$2 billion. Further assume that the average age of foundations, consistent with this estimate of tax savings, is 20 years (as of 1968).

B. Comparison of Foundation Distributions With Government

Use of Tax Savings

On these assumptions, one might ask, "What would have been the cumulative amount of "benefits" to society if no deductions had been allowed and if the Government had distributed 6 per cent per year of its returns on the \$2 billion of additional revenues, assuming that these returns were equal to 6 per cent per year of the net - of -

distributions amount of the \$2 billion of revenues? How does this cumulative amount of Government benefits compare with the cumulative amount of foregone foundation distributions, given the actual rate of growth of such distributions?"

Given these assumption, Government benefits distributed to society in amounts equal to the earnings on the \$2 billion of additional revenues would have aggregated roughly \$2.9 billion from 1948 through 1972. If donors had not been allowed to deduct these contributions, and if their donations to foundations had been less than assumed above in an amount equal to the additional taxes they would have paid, then the cumulative amount of foregone distribution by foundations to charities from 1948 through 1972 would have been roughly \$11.3 billion.¹ Even if the foregone foundation distributions had been only half as much --- \$5.6 billion --- as estimated, and if the Government's use of the additional tax revenues had provided half again as much additional benefits --- \$4.4 billion, it is clear that the lost foundation distributions would have substantially exceeded the additional benefits from Government.

Granting the imprecision of these calculations, they nevertheless strongly urge that there is little factual justification for the notion

1. This assumes that the initial foundation distributions in 1948 would have been half the amount estimated for that year and that distributions would have increased at the same average annual rate --- 10.1 per cent --- as over the years 1955 - 1971.

that foundation payouts have been an inadequate return to society for the tax deductions society has given their donors. Indeed, relatively few government spending programs could meet the benefit-cost standards implied by foundation distributions in relation to tax savings to the donors of foundations' assets.

FINANCE SUBCOMMITTEE ON FOUNDATIONS
Panel Discussions - October 2, 1973EFFECT OF THE TAX REFORM ACT OF 1969
ON PRIVATE FOUNDATIONS --
DIVESTITURE UNDER SECTION 4943

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Introduction

Under Section 4943, as added by the Tax Reform Act of 1969, generally a private foundation and disqualified persons may own between them no more than 20 percent of a business enterprise. When an interest in excess of this limitation is acquired by bequest or gift, the foundation is given five years within which to reduce the holdings to the limit set in the statute. More generous rules apply with respect to foundations in existence on the effective date of the statute (May 26, 1969) or funded under wills extant on that date and unchanged thereafter. Generally, the holdings of such foundations may be 25 percent, provided the holdings of the foundation and disqualified persons do not exceed 50 percent. Finally, with respect to excess business holdings as of May 26, 1969, transition rules permit extended periods up to 25 years within which divestiture may be accomplished.

The requirements of divestiture under Section 4943 have their origin in the concern that a charitable organization's significant investment in a business may cause its managers to "become so interested in making a success of the business, or in meeting competition, that most of their attention and interest (is) devoted to this with the result that what

was supposed to be their function, that of carrying on a charitable, educational, etc., activities (is) neglected." (See "General Explanation of Tax Reform Act of 1969", Staff of the Joint Committee on Internal Revenue Taxation, page 41.) In a sense it was a response to the absence of any law providing guidance as to "(the) point (at which the) * * * noncharitable purposes (of managing a business become) sufficiently great to disqualify (a) foundation from exempt status." ("General Explanation", supra, page 40) This concern was not confined to the situation where a donor or his family utilizes a foundation to retain control of a family concern, large or small. "Even where such a foundation attains a degree of independence from its major donor, there is a temptation for its managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties." ("General Explanation", supra, page 41)

If we accept Congress's premise, then it is pertinent to examine whether or not Section 4943 effectively prevents the kind of excess business holding which Congress felt was dangerous to the charitable purposes for which a foundation is granted exemption. At the outset, it should be stated that there is little, if any, indication as to the effect of Section 4943. This follows from the fact that there is a period of at least five years, namely, until May 26, 1974, within which foundations may comply with the strictures of the statute if in effect they apply. In addition, there are in the statute a number of transition rules extending the period of compliance in certain circumstances.

The lack of pressure with respect to the effect of Section 4943 is demonstrated by the fact that the regulations under this section were promulgated in proposed form only in January of this year after the regulations with respect to most of the other sections have been adopted.

Other provisions of the statute, particularly Section 4942, which beginning in 1972 imposed upon private foundations a requirement of paying out the greater of its investment income or a fixed percentage of the fair market value of its assets, have exerted considerable pressure on foundations to divest themselves of low-yield assets. In many cases the divestiture is of stock of the nature which may or will be subject to the strictures of Section 4943. Experience with these divestitures suggest that there may well be problems with the implementation of Section 4943 when and as it becomes effective.

Disqualified Persons - Definitional Problems

It is too early, therefore, to determine to what extent the divestiture requirements effectuate the purpose of Congress. There is some indication, however, that the provisions may be so rigid as to work considerable hardship and inequities on foundations which in fact are not in the least involved in the operations of the businesses in which they may have substantial interests. This, in part, flows from the interaction of Section 4943 with the definition of "disqualified persons" under Section 4946, since it is the holdings of both the foundation and the "disqualified persons" which effectively determine the "excess business holding" to be disposed of.

The definition of "disqualified person" had its origin in the outright prohibitions against self-dealing under Section 4941. Thus, understandably the definition of "disqualified person" under Section 4946 is extraordinarily broad. However, its application to the excess business holdings provision results in presumptions of common interest and concerted action which simply are not justified. This is particularly true insofar as the family relationships are concerned. The descendants of a donor to a foundation who share ownership of a business enterprise with that foundation may be and often are totally estranged from the foundation itself. To lump their shares with the foundation's for the purpose of determining whether or not an excess business holding exists can be totally unrealistic and result in a determination that the foundation has excess business holdings. In such case, the correction can only be made by foundation divestiture which for reasons discussed below may not be possible.

The penalty which may be imposed upon the foundation having excess business holdings by reason of purchases by disqualified persons demonstrates the strange results which can flow from the statute. If a foundation, either because of the regular rules or the grandfather clause, is at the limit of its excess business holdings, then the purchase of stock in the company by a disqualified person results in an immediate penalty of 5 percent of the value of the purchase. Assume that the estranged wife of a grandson of the substantial contributor to the foundation is the 35 percent beneficiary of a trust managed by a corporate trustee totally

unrelated in any way whatsoever with any of the parties (including the wife). (There are more liberal rules with respect to foundations in existence on May 26, 1969, or funded under wills effective on that date and unchanged thereafter.) If after May 26, 1979, the trustee purchases as a legitimate investment for the trust a share of stock of the company (and the foundation may not know of the trust or even the wife and the trustee have no knowledge of the restrictions of the Code), then there is an immediate 5 percent penalty imposed upon the foundation in addition to the requirement that it dispose of a share of stock.

However strict the definition of "disqualified persons" for self-dealing purposes, it should be subject to correction on the basis of the realities of the situation in applying Section 4943.

Transition Rules

As indicated, the statute includes a number of special transition rules with respect to foundation holdings as of May 26, 1969. Some extend the period of time within which excess business holdings as of that date may be disposed of. Others permit variance from the basic rule that the permitted holdings of any foundation in a business venture must be, when combined with the holdings in the voting stock of disqualified persons, no more than 20 percent. (The holdings of the foundation and disqualified persons together may be 35 percent if the Secretary of the Treasury is satisfied that effective control of the corporation is in individuals or entities which are not disqualified persons.) The transition rules clearly represent an attempt at a generalized statement to cover a number

of specific situations which were brought to the attention of the Ways and Means and Finance Committees. As a compromise reached in conference, it is quite remarkable. As a provision of law, it is practically incomprehensible.

Because of the difficulties of disposition outlined below, it would seem that, where a new foundation is created or an old foundation funded with post-May 26, 1969, assets, the extended periods of time of the present transition rules should apply. Under the present law, a foundation would have only five years within which to dispose of such excess business holdings. Although some pre-death planning could be made, it seems appropriate to suggest that extended transition rules apply with respect to excess business holdings acquired by bequest.

Disposition of Excess Business Holdings

The problems which have arisen in connection with dispositions encouraged or required by Section 4942 clearly suggests that there may be serious problems ahead for a foundation attempting to comply with the divestiture rules. This may be as true of an interest in a small closely held corporation as an interest in a large company whose securities are traded on a national exchange. The fact is there are almost certain to be circumstances whereunder the foundation will not be able to comply with the divestiture requirements within the period set by the statute.

(a) Marketability

There may in fact be no market whatsoever for the securities. In the case of a small closely held corporation whose stock is not listed on any exchange, the only potential market may be the company

itself. It is possible that for one reason or another the company may be a disqualified person, in which case a transaction between the company and the foundation could be an act of self-dealing. Assuming that this is not the case or that certain transition rules apply, the company may be financially unable to purchase the stock. In many cases, the company will be controlled by persons ("disqualified" or not) who are not interested in or antagonistic toward the foundation. If the stock is in fact a minority interest, there may well be no market for its sale.

Even if the corporation is one whose securities are listed on an exchange and even if the foundation's holdings are not restricted as to sale, market conditions may be such that the excess business holdings cannot be disposed of in the period set forth in the statute without seriously depreciating the value of the stock held. The forced sale in this case would work a serious hardship not only on the foundation but on the other stockholders of the company.

(b) Restrictions on Sale

Quite often the kind of holding which may be "excess" under Section 4943 is of a block of securities in the company of the foundation's founder which is subject to restrictions as to sale even though the securities of the company are traded regularly on a national exchange. This is especially true of a number of relatively large foundations.

Under the Securities Acts and the rules of the Securities and Exchange Commission, such stock is salable by the foundation only if certain conditions are met:

(1) Under certain circumstances, the stock may be sold in a private transaction with a purchaser who is deemed to be sufficiently sophisticated and knowledgeable as not to need the protection which the registration described below provides. The rules with respect to such transactions are strict. The securities as acquired by the purchaser are subject for a substantial period of time to the same restrictions as to sale which are imposed upon the foundation and the purchaser must in effect certify that the assets are acquired for investment purposes. Because of the penalties imposed on both parties to the transaction, sale after an extended period of time may be made only upon satisfying the seller that the rules of the Securities and Exchange Commission have been met. The potential of any substantial blocks of excess holdings being sold by private transactions is limited.

(2) Sales under SEC Rule 144 -- The foundation may be able to dispose of some of its shares on the open market under a rule of the Securities and Exchange Commission recently modified (Rule 144). Under this, in effect every six months the foundation can dispose of a certain number of shares. The number of shares which may be disposed of is the lesser of one percent (1%) of the outstanding shares or the average of the weekly number of shares sold on the exchanges during a specified period. There are rules which may require the foundation to aggregate these

sales for purposes of the limitation with the sales of other parties for a period of time, thus, further limiting the number of shares which can be disposed of. The problems of selling restricted securities under Rule 144 are discussed in detail in a paper which will appear in the forthcoming issue of "The College Counsel", the journal of the National Association of College and University Attorneys ("Rule 144: The Applicability of the Restricted Securities Requirements to Colleges and Universities", Bruce R. Hopkins). A copy of this as yet unpublished article is enclosed for reference purposes. In many cases, the number of "excess business holding" stock which a foundation could dispose of in the time would be relatively minor compared to the disposition required.

(3) Registration -- The only feasible alternative may be to register the securities for sale in a public offering. The first question which must be faced is whether there is a market for any of the shares which must be disposed of and, if there is, how many of them may be disposed of without disturbing the marketplace to the detriment of the other shareholders. If the company has never made a public offering before, then there is a serious question as to whether or not a market would exist. At the present time, for instance, very few new offerings are being made because of the economic situation. In other times, certain kinds of business enterprises would be received on the marketplace and others might not.

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In the case of a large concern, the holdings of the foundation, although a relatively small percentage of the outstanding shares, may be absorbable by the market only over a long period of time in a series of registrations. It is to be noted that the registration route is quite expensive and is, therefore, available only where large sums are involved. Even if the market conditions are such that a sale of all or a portion of the excess business holdings is appropriate, the registration for sale of securities of a shareholder (a so-called "secondary offering") might practically be impossible because under the law it can be made only by and through the company. There are many good and valid reasons why a company might not wish to register securities for sale.

The problems with respect to finding a market, the restrictions imposed by law and sale are such that foundations under legal requirement of divestiture under Section 4943 may well be unable to comply. They will, thus, become subject to automatic fine and perhaps continuing penalties. In other cases, where the institution can literally comply with the requirement of divestiture, the act of compliance may seriously damage the interest of other shareholders in the business enterprise. Under these circumstances, clearly there ought to be discretion in the Secretary to grant extensions of time within which foundations may dispose of excess business holdings.

Conclusion

As the above indicates, the structure of Section 4943 is such as to require many foundations to dispose of assets which are in no way involved in the business in which they are alleged to have excess business holdings. Thus, Congress's purpose is in no way being furthered by the required divestiture. If we accept the necessity of having a fairly objective mathematical basis for determining what is an excess business holding, then at the very least the definition of "disqualified person" for the purpose of Section 4943 should be subject to challenge on the part of the foundation. There is no reason why the Secretary should not be given the discretion to find that an individual or entity identified as a disqualified person is not such for the purpose of the statute. By the same token, as indicated above, it is quite clear that under some circumstances foundations will not be able to comply with the requirement of divestiture imposed by Section 4943. The imposition of an automatic tax to bring about this divestiture can, in these circumstances, have no effect whatever. It would seem much more reasonable, as in the case of the definition of "disqualified persons", to give the Secretary of the Treasury discretion to extend the period within which divestiture is required, perhaps upon the basis of a plan of divestiture which meets with the Secretary's approval. (In this connection the more liberal self-dealing rules with respect to redemption of excess business holdings might well be extended.) Finally, if extended transition rules were appropriate with respect to the time of disposition of excess business assets when the statute was enacted in 1969, then they

are equally appropriate with respect to a new or enlarged foundation created or funded by bequest after that date.

Most of the discussion above has dealt with the overreaching of the statute insofar as excess business holdings are concerned. This does not mean to say that the statute clearly reaches every foundation holding with respect to which there may be excess involvement in business enterprises. For example, it has been suggested that the use of a holding company may provide a means for avoiding some of the restrictions of the Act. Further, there are some results which seem strange in light of the purposes. For example, if a foundation on May 26, 1969, owned 25 percent of the stock of the company on May 26, 1969, and if upon his death the founder bequeathed an additional 25 percent (under a will in effect on May 26, 1969) to another foundation controlled by the same parties as control the first, then it may be that the separate interests can be retained by each entity. This results from the grandfather rules and the fact that the two commonly controlled foundations are not treated as one but each is treated as a disqualified person vis-a-vis the other. Such examples are bound to come to light as the time approaches for giving effect to the statute.

Before closing, mention should be made of the proposal which was made by Congressman Patman in introducing H.R. 5729 earlier this year and considered by the Subcommittee on Domestic Finances of the Committee on Banking and Currency of the House of Representatives in hearings on April 5 and 6. This bill would require further divestiture with the purpose of imposing diversification on foundations. Under the bill, a foundation

would have five years within which to reduce its holdings in any one security to 10 percent of its assets. Such a provision would impose a far heavier burden of disposition on private foundations than than required by Section 4943. If, as is suggested, foundations holding interests in business may well experience considerable difficulty in complying with the schedule of divestitures imposed by the Tax Reform Act, then it appears that the burden of complying with divestiture proposed in H.R. 5729 may well become intolerable. The purpose of such a provision is seriously to be questioned. As indicated above, there is every indication that the divestiture provision of Section 4943 will effectively end foundation involvement in the control of business enterprises. At the very least, the statute should be given an opportunity to work. Moreover, foundations, other than exempt entities, are generally subject to the local "prudent man" rules with respect to management of investment assets. It is doubtful a rigid rule such as proposed is appropriate in regulating the investment policy of any organization. If serious consideration is given to the proposal, extended transition periods similar to those provided in the Tax Reform Act should be available not just from the effective date of the statute but also from the time a foundation is funded. Furthermore, as indicated above, the Secretary must have discretion to extend the period further where the circumstances warrant.

**SUMMARY OF POINTS
MADE IN THE ATTACHED STATEMENT
SUBMITTED TO SUBCOMMITTEE ON FOUNDATIONS,
COMMITTEE ON FINANCE, UNITED STATES SENATE,
BY JOHN G. SIMON**

1. Private foundation death rates appear to have increased, and birth rates appear to have sharply declined, since the passage of -- and as a result of the provisions of -- the Tax Reform Act of 1969.

2. While some have raised questions about the depth and permanence of the death rate increase, there is no doubt that the Tax Reform Act will continue to have a highly negative impact on the birth rate. (Birth rate involves both the formation of new foundations and the contribution of capital to existing but not-fully-funded foundations.)

3. This negative impact principally results from two provisions which directly discourage contributions to private foundations:

(a) The new rule pertaining to contribution of appreciated property (Code Section 170 (e)), which, in effect, permits all charitable organizations except private non-operating foundations to receive gifts of appreciated property without subjecting the donor to tax on the long-term capital gain.

(b) The excess business holdings provision of the Act (Code Section 4943), which, in effect, prevents a foundation from receiving a gift of the donor's corporate control stock unless the combined voting interest of the foundation and the donor is brought below 20% within five years.

4. The significance of these two provisions, for birth rate purposes, can be appreciated in the light of the fact that prior to the Tax Reform Act,

(a) approximately 80 percent of gifts to foundations with more than \$1 million in assets were composed of gifts of appreciated property;

(b) more than half of foundations with more than \$10 million in assets had, at one time, held stock of companies in which the foundation and the donor together held a 20 percent interest -- i.e., a holding to which the divestiture provision of the Tax Reform Act applies.

5. A retarded foundation birth rate, as a result of the foregoing provisions, has an unhealthy impact on the field of "private charitable enterprise," for the following reason:

(a) There are only about 350 foundations in the \$10 million-and-over class -- i.e., with enough resources to be major sources of financing for new ideas and approaches.

(b) Only one or a handful of these 350 foundations may operate in a given field of work (e.g., mental health,

pollution control) or in a given geographical sector. Accordingly, persons and groups seeking funds for new programs often have very few doors on which to knock. (c) A declining rate of entry into the foundation field will further reduce the already limited options available to those who seek financing and, at the same time, will leave the remaining foundations in a particular field of work or a particular region with an undesirable degree of power to determine the rate and form of social and scientific innovation.

6. No persuasive rationale is found in the legislative history of either the appreciated property or excess business holdings provisions for imposing these rules solely on the private foundations. Moreover, limiting these rules to foundations sharply limits the effectiveness of the appreciated property provision as a tax reform measure and the effectiveness of the excess business holding rule as an abuse-policing device (for other public charities can take the foundations' place as holders of corporate control stock). Moreover, the abuses to which the excess business holdings provision was addressed can be cured by specific remedies less drastic than divestiture.

7. Because there is not an adequate justification for imposing the appreciated property and excess business holdings restrictions solely on the private foundations, and because such discrimination restricts entry into the foundation field and thereby impairs the health of "private charitable enterprise," it is respectfully suggested that these discriminatory features of the Tax Reform Act be eliminated. (With respect to the excess business holdings provisions, at the very least it is suggested that the disincentive effect of the provision be minimized by substantially extending the deadline for divestiture beyond the five-year period set forth in the statute.)

STATEMENT OF JOHN G. SIMON,
PROFESSOR OF LAW, YALE UNIVERSITY,
SUBMITTED TO SUBCOMMITTEE ON FOUNDATIONS,
COMMITTEE ON FINANCE, UNITED STATES SENATE,
OCTOBER 2, 1973

Is the private foundation, as a result of the Tax Reform Act of 1969, an endangered species? An article appearing in the Tax Law Review one year after the Act's passage offered such a prognosis:

"The bell may well have faintly tolled for the private foundation; it is now to be found only in captivity and there are strong doubts about its ability to reproduce."

Early returns provide some support for this grim estimate. The death rate for private foundations appears to have increased since 1969, and the birth rate appears to have plunged. Neither from the I.R.S. nor from any other source can we yet obtain data that permit a systematic review of the demographic trend, but the clues are plentiful.

Death Rate Evidence

As for deaths, we have these clues:

(a) Each month the Internal Revenue Bulletins announce exempt organizations which "have terminated their existence or, for other reasons, no longer qualify as organizations [eligible to receive deductible contributions]." The Council on Foundations has examined the bulletins for a sample month (May) since 1968 (the Tax Reform Act was enacted in December 1969), and finds the following numbers of terminating organizations that appear to have been private foundations:

May, 1968	11
May, 1969	23
May, 1970	29
May, 1971	31
May, 1972	55
May, 1973	74

(b) The New York State Attorney General's Office reported to an American Bar Association committee in 1972 that in 1969, 1970 and 1971 the following numbers of private foundations had dissolved with the consent of that office:

1969	28
1970	76
1971	91

(c) Charles W. Rumph, Assistant Attorney General of California, reported to the Subcommittee on Domestic Finance of the House Committee on Banking and Currency, in April 1973, that "[p]rivate foundations are being dissolved at a rate nearly double what it was prior to the [Tax Reform] Act."

(d) The Council on Foundations, basing its information on monthly Internal Revenue Bulletin termination announcements, estimates that there were approximately 624 foundations included in the terminations reported during the first eight months of 1973.

(e) Twenty community foundations have reported to the Council on Foundations that between January 1, 1970 and the summer of

1973, they received the assets of 91 dissolving private foundations; the transferred assets had a market value in excess of \$60 million.

(f) A report by The Conference Board, "The Impact of the Tax Reform Act of 1969 on Company Foundations," states that 24 out of 240 company foundations "have either been terminated or are in the process of being phased out."

Birth Rate Evidence

The birth rate phenomenon has two components: formation of new foundations and the addition of capital to existing, not-fully-funded foundations. With respect to the first point, the following evidence strongly suggests a reduced rate of formation:

(a) The Council on Foundations has counted the number of "new organizations" which appear to be private foundations and which are listed in two supplements to the I.R.S. Cumulative List of Organizations - Supplement 1969-1 (Jan.-Feb. 1969), published prior to the Tax Reform Act, and Supplement 1973-1 (Jan.-Feb. 1973), published three years after the passage of the Act. The results:

Jan.-Feb. 1969 Supplement: 433 new private foundations

Jan.-Feb. 1973 Supplement: 181 new private foundations

(Even the January-February 1973 figure of 181 foundations may be misleadingly large. Many of these organizations may have been created prior to passage of the Act but were only recently added to the Cumulative List because of the notice provisions of Code Section 508 and other factors. Other foundations among the

list of 181 may have been formed after passage of the Act but in accordance with provisions contained in wills executed, or trusts created, prior to passage, i.e., provisions not affected by the Act.)

(b) On April 24, 1972, the Committee on Charitable Trusts of the American Bar Association's Section on Real Property, Probate and Trust Law reported, on the basis of a survey of 90 law firms in New York State and reports from other states, that, "[b]ecause of the burdens of the Tax Reform Act, there has been a marked slowdown in the establishment of new private foundations."

(c) In a survey published last January in TAXES magazine, 13 lawyers and accountants representing 256 private foundations stated that they would have recommended formation of only one quarter of these foundations had the Tax Reform Act been in effect at the time of creation. Twelve of these advisors also reported that they had in fact recommended the formation of 17 foundations since passage of the Act, compared to the 36 they would have recommended if there had been no change in the law.

On the second aspect of birth rate, contribution of new capital to existing foundations, the available information is quite spotty. But once again there are clues:

(a) The Council on Foundations has examined two random samples of 100 foundations with assets of more than \$5 million. The first sample of 100 foundations was examined for gifts

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received in accounting years ending before January 1, 1970; the second sample of 100 foundations was examined for gifts received in accounting years beginning after December 31, 1969. The examination showed that:

42 foundations in the first group received gifts in 1967, 1968 or 1969, totaling in value \$37 million; 29 foundations in the second group received gifts in 1970 or 1971, totaling in value \$35 million.

This comparison probably does not begin to measure the full impact of the Tax Reform Act on gifts to existing foundations, for many of the gifts received by the second group of foundations appear quite clearly to have been made under wills executed or trusts created prior to the passage of the Act; in other words, if only gifts under post-Act instruments were counted in the second group, the drop-off would be much more marked. (Unfortunately, one cannot always tell from the information returns whether or not a gift received by a foundation was made under a pre-Tax Reform Act instrument.)

(b) The Conference Board's report on the impact of the Tax Reform Act states that "there is abundant evidence that gifts of appreciated property to company foundations have been either cut back sharply or eliminated and there is no reason to expect any change in this situation."

Impact of The Tax Reform Act

Is the Tax Reform Act responsible for these death-and-birth phenomena? One can argue that the terminations result from cyclical causes -- an

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historic fall-off in enthusiasm for private foundations - and that such an explanation, coupled with the severe turbulence in the stock market, also accounts for the reduced birth rate. But there seems little reason to dispute the first-hand testimony of the 13 foundation lawyers and accountants, referred to earlier, who unequivocally attribute recent liquidations and reduced births to the Tax Reform Act.

The foundation species, then, seems to have been somewhat endangered by the 1969 legislation. Some observers, however, including some of the 13 tax advisors mentioned above, believe that mortalities will mainly be found among the smaller foundations; other foundation-watchers, including the ABA committee quoted above, believe that it is too early to announce a long-run death rate trend: "for the time being, most private foundations appear to have assumed the burdens and are prepared to continue, keeping a careful eye on their experience as it develops." But the observers have not been so cautious when it comes to the long-run reproductive capacity of the foundations, involving formation and expansion; I have heard no dissent from proposition that the birth rate prospects are bleak.

The reasons for this prognosis are simple enough. Consider the matter from the perspective of the person who contemplates starting a foundation or adding further capital to a foundation already established. Not only does this person have to consider the administrative burdens, the program restrictions, and the investment tax and payout obligations now imposed on foundations; the prospective founder also confronts three other rules which are specifically related to - and directly discourage - the process of creation or expansion.

First, there is the 50-20 differential in the percentage of adjusted gross income a donor can annually contribute in cash to a "public charity"

(50%) as compared to a non-operating foundation (20%), coupled with the donor's inability to use a carry-over for excess contributions to a foundation. Even more important disincentives are the following ones.

Second, there are the appreciated property rules (amended Code Section 170(e)), which cause, in rough effect, a realization of long-term gain when appreciated property is given to a non-operating private foundation, unless the foundation redistributes these assets within a year. In other words, the gift of appreciated property to a foundation (for other than "pass-through" purposes) receives dramatically less favorable treatment than the gift of the same property to other charities. Yet most contributions to foundations prior to the Tax Reform Act consisted of appreciated property; in October 1969 the Peterson Commission reported to the Senate Committee on Finance that, in a recent period of time, 78 percent of gifts to foundations in the one-to-ten-million-dollar asset category consisted of appreciated intangible property; for foundations with assets of one hundred million dollars and over, this figure was 88 percent. In short, the inevitable effect of the new appreciated property rules is heavily to discourage contributions to private foundations. A donor can continue to make such contributions without adverse tax effect if he does so under his will; the estate tax has not been changed in this respect. But most foundation donors want to begin to fund their foundations while they are alive; if they have to wait until death for the foundation to get going, there is a good chance that they will not start at all.

The third provision to which I refer discourages testamentary as well as inter vivos gifts to foundations: the excess business holdings rule (Code Section 4943), which in effect prevents a foundation from receiving

a gift of any but a de minimis part of a donor's corporate control stock unless the combined voting interest of the foundation and the donor is brought below 20 percent within five years of the gift. As the 1969 legislation went through the Senate, liberalizing provisions were inserted to permit foundations to hold on to their existing corporate control stock for much longer periods of time -- up to 25 years in some cases. But no such liberalization was provided for post-1969 gifts to new or old foundations. It is true that even these post-1969 gifts are treated somewhat more favorably than under the 1965 or 1969 Treasury Department recommendations, but the five-year deadline will still present great problems for many a potential founder whose nest egg consists of a family business interest. ¹ (Ease of redemption is, of course, a factor, but while the Tax Reform Act removed accumulated earnings tax obstacles to the redemption of stock held by foundations prior to the passage of the Act, it failed to remove such obstacles to the redemption of stock donated after 1969.) The impact of this provision on the birth and expansion of foundations can be easily appreciated if we consider the fact, reported by the Peterson Commission, that substantially more than half of all foundations in the ten-million-dollar-and-over asset category have held, at one time, stock of companies in which the foundation and the donor together owned a 20 percent interest -- precisely the form of asset covered by the Tax Reform Act prohibitions.

1. It should be noted that I am referring only to the provision affecting post-1969 gifts to foundations, not the provision relating to post-1969 purchases of business interests by foundations; the latter rule does not affect the birth rate problem, and I have no quarrel with it.

The Public Policy Implications

One factor that contributed to the enactment of all of these birth rate discentives was that the foundations yet to be born were not able to represent their own interests before the Congress, and the existing foundations, for the most part, were too busy dealing with their own pressing problems to fight the cause of the unborn. As a result, a very important public policy point got largely overlooked in the 1969 deliberations -- one that significantly affects the health of the philanthropic sector.

While there are many thousands of foundations in the country, there are only 350 which have assets in excess of \$10 million; only the members of this group have an annual giving capacity of more than approximately half a million dollars and therefore a capacity to engage substantial professional assistance. It is largely to these 350 foundations that individuals and organizations must turn to gain substantial foundation financing for new programs and approaches. Moreover, to obtain support in any one field of work (for example air pollution, crime control, mental health), or in any one area of this country, an organization can turn to only a handful of these foundations, for, in order to husband their resources, most foundations must specialize to some extent. In the course of time, even the small group of foundations dealing with a particular problem -- or operating in a particular geographical region -- will be reduced in size by dissolution, or reduced in effectiveness by the onslaught of tired blood. This circumstance has a significant impact on the performance of individual foundations and on the overall functioning of the philanthropic marketplace.

A foundation's performance inevitably suffers from its status as the

only substantial foundation (or one of the few substantial foundations) that resides in a particular state or region or that deals with a particular topic — to be the only foundation interested in urban design in New England, for example, or the only foundation in the Southwest interested in mental health. A foundation in this situation may be regarded as the relief agency for all groups operating in its field, with the result that it may deny no one — it may try to provide some small, fractional solace to all who knock on its door. That is not the way to promote adventurous philanthropy.

On the other hand, if the foundation says "no" to an applicant, that answer may represent the applicant's first, second, and third strikes. The fact that the applicant may have no other place to turn in the marketplace for grants presents a serious matter of public policy. For the purpose of increasing the capacity of our society to respond to its vast and varied challenges, we need to offer a variety of funding options to those who have new ideas for solving our problems. Here, in the area of "private charitable enterprise," as in the area of private commercial enterprise, a decreasing rate of new entry into the foundation field would, over time, leave the remaining foundations with an undesirable degree of power to determine the rate and form of social and scientific innovation. A decreasing birth foundation rate thus impairs pluralism in the charitable world.

A Justification for the Provisions?

If these are the negative consequences of the appreciated property and excess business holdings provisions, what is to be said on their behalf?

Perhaps the appreciated property provision was meant to promote the cause of tax reform, to respond to the demand that taxpayers be prevented from escaping the capital gains tax normally resulting from dispositions of appreciated assets. But, if so, it seems strange indeed to impose such a

basic reform on only one group of charitable contributors, the donors to foundations, whose gifts represent only a fraction of the total problem. The House and Senate Committees did not provide an answer to this puzzle when they reported out the Tax Reform Act. Despite the fact that the appreciated property rule was not located in the part of the Act dealing with foundations, the Committee reports made no attempt to explain why this reform measure should apply only to those taxpayers who give to foundations.

As for the excess business holdings rule, the House and Ways and Means Committee explained that the new provision sought to combat three quite specific evils said to be inherent in foundation ownership of corporate control stock. One of these complaints -- the "diversion" of the foundation managers' attention to business affairs, "away from their charitable duties" -- is difficult to understand logically or to sustain empirically. To the extent that they are factually significant, the other two evils -- the low

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2. A small foundation, without a staff, will be run by members of the family who would, in any event, be spending some of their time on business, some of their time on philanthropy. It is difficult to see why the amount of time devoted to philanthropy would be any less, merely because the family's philanthropic interest (the foundation) happens to be linked to the family's business activity (the controlled corporation). On the other hand, the foundation large enough to have a substantial professional staff will have employees who are spending full time on philanthropy and lay trustees who would not be devoting full time to foundation affairs in any event. Moreover, the diversified portfolio of a non-corporate-controlling foundation may require just as much financial attention as the single predominant investment of a corporate-controlling foundation. Finally, logic aside, the roster of corporate-controlling larger foundations contains many names of distinguished foundations (e.g., Danforth, Lilly, Hartford, Irwin-Sweeney-Miller) which go about their charitable work without being "diverted" by the nature of their business holdings.

productivity of some corporate control stock and the allegedly unfair business advantage accruing to some foundation-controlled companies -- are correctable in large part by other provisions of the Tax Reform Act, as supplemented by other specific remedies that can be enacted in lieu of a total divestiture rule. In short, any abuses that are generated by the corporate control phenomenon can and should be handled with these specific techniques rather than radical surgery.

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3. The low-yield phenomenon, where it is found, can be corrected by a combination of the minimum payout requirements of Code Section 4942, coupled with vigorous enforcement of the existing tax on accumulated corporate earnings. To give further assurance of productivity, the law could prohibit or penalize a foundation's retention of corporate-control stock unless the annual return on that stock, measured alone, equalled the minimum percentage which, under the Section 4942 payout provision, the foundation is required to distribute each year.

With respect to any unfair competitive advantage a foundation-controlled business (although fully taxed) may enjoy, the advantage would be substantially reduced if, through the techniques suggested above, foundations were placed under pressure to exact an adequate dividend payout from their controlled companies. Moreover, the Tax Reform Act in Code Section 4941 prevents a foundation from making any loan, on preferential terms or otherwise, to any corporation 35% owned by the donor's family. In the interest of preventing unfair competitive advantage, this provision could be expanded to prohibit a foundation from providing debt or equity financing to a controlled business except (a) through the purchase of its securities from unrelated third parties on a national exchange, or (b) with the approval of the I.R.S. or the state court having equity jurisdiction.

I suggest that, in any event, these two problems are not as serious as is frequently asserted. My reasons are set forth in detail in vol. 1, House Committee on Ways & Means, "Written Statements ... on Treasury Department Report," 89th Cong. 1st Sess. (1965), pp. 458-462.

Moreover, in the case of the excess business holdings rule, as in the case of the appreciated property rule, we are left to wonder why this reform measure was directed only at the foundations.⁴ Conceivably, Congress thought that only foundations were likely recipients of corporate control stock or at least the only entities likely to "cooperate" with the donor in suppressing dividends or committing other abuses. But there are hundreds or thousands of financially hard-pressed colleges and churches which would be delighted to receive control stock, with all kinds of informal voting understandings. And for such a church or such a school, there are no self-dealing rules and no minimum-payout rules to regulate abuses; the churches do not even have to file an information return. Accordingly, to the extent that corporate control stock now is diverted from foundations to non-foundation charities -- and there is evidence that such diversions are being actively solicited -- we may be worse off from a regulatory viewpoint.

Conclusion

Because the case for discriminating against foundations with respect to the appreciated property and excess business holdings provisions has not been made, and because such discrimination restricts entry into the foundation field and thereby impairs the functioning of the philanthropic marketplace, I

4. The problem of the foundations' least-favored-nation treatment under the Tax Reform Act, with respect to the excess business holdings rule as well as other provisions, is discussed by Professor Boris Bittker in "Should Foundations Be Third-Class Citizens?", a chapter in Fritz Heimann (ed.), The Future of Foundations (1973), pp. 132-162.

respectfully urge this Subcommittee to give careful consideration to the views expressed by the representative groups of citizens convened by The American Assembly within the last year. The 72 participants in the Western Assembly, meeting at San Francisco in June 1973, took the position that

"[t]he 1969 Tax Reform Act favors public charities over private foundations and should be modified so that public and private charities are similarly treated,"

and the 72 members of The Forty-first American Assembly, meeting in New York State last November, stated,

"We question the soundness of the differences in tax incentives between foundations and other charities established by the 1969 tax legislation."

Even more to the point of this discussion, The Forty-first American Assembly announced that

"[c]oncern was expressed about provisions in the law that may adversely affect the incentives for establishing new foundations, particularly the provisions regarding the donation of appreciated property and the restrictions on the holding of control stock. From the public's point of view, the new energy and new ideas that can come from the establishment of new foundations must be encouraged."

If "new energy and new ideas" are to be generated with the help of new foundations, the discriminatory features of the Tax Reform Act that retard the foundation birth rate ought now to be re-examined and, in my opinion, eliminated. (If the Congress is not willing to take such action in the case of the excess business holdings rule, I suggest that Congress should at least minimize the disincentive effect of the provision by substantially extending the deadline for divestiture beyond the five-year period set forth in the statute.)

As the appreciated property and excess business holdings provisions now stand, they are likely to inflict serious damage on our system of "private charitable enterprise," for that system, as Kingman Brewster, Jr., has stated,

"rests. . . on the great importance of giving each new idea a chance to find a sympathetic sponsor by offering it more than one doorbell to ring. Innovation is the essence of progress. Independence and variety are the essence of a free society. Both seem to make it absolutely essential that an idea, a person, an institution not be dependent on the ability to persuade or to please any single source of support."

NOTE

Although this statement grows out of my academic studies of tax policy relating to philanthropy, for the purposes of full disclosure I should mention that I also serve as the President of the Taconic Foundation, an organization which is not, and is not likely to be, affected by the legislation under discussion in this statement.

October 2, 1973

HEARINGS OF SUBCOMMITTEE ON FOUNDATIONS

SENATE FINANCE COMMITTEE

Outline of Testimony by

MALCOLM L. STEIN

Attorney (District of Columbia and New York); Formerly Lecturer-in-Law, Columbia University School of Law, 1965-1969; Formerly Attorney-Adviser, Office of Assistant Secretary of the Treasury for Tax Policy, 1969-1971; Firm, Roberts & Holland, New York, New York.

- I. Introduction
- II. Taxes and penalties on foundations and managers
 - A. Taxes on self-dealing illustrate the statutory pattern
 - B. Specific problems involving penalties upon foundations and their managers
 1. Self-dealing
 2. Income distribution
 3. Lobbying and political activity
 4. Liability to state penalties
- III. Effect of Tax Reform Act of 1969 on birth rate and mortality rate of private foundations
- IV. Equitable remedies
- V. Conclusion

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I. INTRODUCTION

The provisions of the Tax Reform Act of 1969 relating to private foundations imposed a comprehensive body of law on these organizations for the first time. The viewpoint of Treasury Department officials as to how the foundation provisions would affect foundations' operations, at least from May 1969 to September 1971 while I was a staff attorney in the Office of the Assistant Secretary of the Treasury for Tax Policy, was not too divergent from the views of State attorneys general and the foundation community.

In general, the Treasury Department viewed these provisions as a set of reasonable restrictions on foundation activities, accompanied by flexible sanctions and penalties which are tailored to the extent of the violation. The self-dealing and income distribution provisions of the Act are

probably the most necessary limitations placed upon the activities of foundations--they will affect the greatest number of foundations and quantum of activities and were the proposals most widely supported by the foundation community in 1969. Of course, the business divestiture requirements and the restrictions on political and grant-making activities will also have a substantial impact on foundations in the future.

In three areas, the foundation provisions of the Act vary somewhat from the Treasury proposals of April 22, 1969. First, Congress imposed a tax of 4 percent of net investment income, which will materially reduce the funds available for charitable purposes. Second, the restrictions on political activities, grant-making, electioneering, and voter registration drives go well beyond Treasury proposals. Third, although the penalties in the Act are more flexible than those in the 1969 House bill, although the violations can be corrected in certain circumstances, and although sanctions are imposed on foundation managers only if they act willfully and without reasonable cause, they do not provide as wide a degree of flexibility as would the Treasury proposal, which was not adopted, for equity jurisdiction in the courts with regard to the imposition of penalties.

This statement deals primarily with the effect of taxes and penalties upon foundation operations, activities,

potential for innovation, and birth rate.

II. TAXES AND PENALTIES ON FOUNDATIONS AND MANAGERS

A. Taxes on self-dealing illustrate the statutory pattern

In 1950, amendments were made to the Internal Revenue Code setting forth specific self-dealing transactions which were prohibited between certain classes of persons and their foundations. Arm's-length standards were imposed with regard to loans, payments of compensation, preferential availability of services, substantial purchases or sales and substantial diversions of income or corpus. Sanctions were the loss of exemption for a minimum of one taxable year and the loss of the charitable contribution deduction under certain circumstances.

The arm's-length standards proved to require disproportionately great enforcement efforts, resulted in reluctance in enforcement because of the disparity between the sanctions imposed and the offense involved, and led to the encouragement of extensive litigation. Thus, Congress found that pre-1970 law frequently did not preserve the integrity of private foundations. Congress further found that even arm's-length standards permitted use of a private foundation to benefit improperly those who controlled the foundation. Section 4941, as added by the 1969 law, expresses the determination of Congress to prohibit self-dealing transactions even on an

arm's-length basis and to provide a variety and graduation of sanctions.

If an act of self-dealing occurs, the first-level tax on the self-dealer is 5 percent of the "amount involved" with respect to each act of self-dealing for each year (or part thereof) from the date the act occurs until the self-dealing is corrected or a deficiency notice is mailed regarding the transaction, if that is sooner. The "amount involved" is the greater of the value of what the foundation gave or what it received at the time of the self-dealing, except that in the case of excess compensation paid for personal services to persons other than government officials it is only the excess compensation which is the "amount involved."

The first-level tax is imposed, jointly and severally, on all disqualified persons who participated in the act of self-dealing other than a foundation manager acting only as such. This tax is imposed even if the violation is inadvertent, except that as to a government official acting in his governmental capacity the tax is imposed only if he knowingly participated in the self-dealing.

In addition, there is a tax of 2-1/2 percent on any foundation manager knowingly participating in the self-dealing, unless the participation is not willful and is due to reasonable cause. The tax may not exceed \$10,000 in the aggregate for all managers with respect to any one act of

self-dealing, and they are jointly and severally liable.

A second-level tax of 200 percent of the amount involved is payable by the persons on whom a 5 percent tax is levied if the act is not "corrected" (i.e., undone to the extent possible). If undoing is not possible, the foundation must be made whole by being placed in a financial position not worse than that in which it would have been if the disqualified person had been dealing under the highest fiduciary standards. Correction must be made within a "correction period" beginning on the date on which the act of self-dealing occurs and ending 90 days after the mailing of the notice of deficiency with respect to the second-level tax, extended by any period in which a deficiency cannot be assessed as a result of the filing of a petition in the Tax Court or any other period which the Commissioner determines is reasonable and necessary to correct the act.

A second-level tax of 50 percent of the amount involved is imposed on any foundation manager who refuses to correct the act of self-dealing, but the maximum tax is \$10,000 in the aggregate for all managers with respect to any one act of self-dealing and the liability of the managers is joint and several. The amount involved for purposes of the second-level tax is determined at its highest fair market value during the correction period.

The type of property involved, the complexity of the

transaction, and the manner in which correction may be accomplished may affect the amount of the taxes imposed under the Treasury regulations.

B. Specific problems involving penalties upon foundations and their managers

A brief selection of problems under the various foundation provisions will serve to illustrate various beneficial or deleterious effects of the rules.

1. Self-dealing

An installment sale between a foundation and one of its managers may involve a sale, a loan, and a transfer to a disqualified person of the foundation's income or assets. The question arises whether the manager should be taxed once or more than once with respect to the same transaction. Such a self-dealing transaction may also be covered by the provisions of section 4945(d)(5), which penalizes any amount paid or incurred by a private foundation for any purpose other than a charitable purpose.

One possible position would be to impose only one tax under a particular Code section for a particular transaction, but to impose more than one tax on the transaction if it is covered by more than one section of the Code. However, perhaps it is too harsh to tax a transaction doubly even in the situation where two different sections are involved. The question then remains whether the Internal Revenue Service should have the option to choose that section which will

produce the highest tax or which has the lightest burden of proof. It is probably too difficult for the regulations to prescribe detailed rules in this area, and the Service should be accorded the discretion to choose the section which it desires to use.

Another untoward consequence of the Act is that many transactions which actually benefit a foundation are penalized because of the elimination of arm's-length standards. For example, a transfer of real property by a disqualified person to a private foundation is treated as a sale or exchange if the property is subject to a mortgage which the foundation assumes or if it is subject to a mortgage which a disqualified person placed on the property within the 10-year period ending on the date of transfer. Thus, in the case of private foundations such a transaction is prohibited rather than merely being limited by the bargain sale rules of section 1011(b).

2. Income distribution

The income distribution requirements imposed on foundations by the Tax Reform Act should generally be considered beneficial, although certain drawbacks are present. Although a large number of foundations have supported these provisions, a majority of foundations will be forced to change their investment and expenditure policies in order to comply with the new distribution rules. Some foundations have al-

ready complained about these provisions and at least two have attempted to get legislative relief.

The high distribution requirement is principally the result of testimony by The Honorable Peter G. Peterson before the Senate Finance Committee in October 1969 when he was the head of the Commission on Foundations and Private Philanthropy. He testified that foundations should be required to make annual distributions to charity in the range of 6 to 8 percent of the fair market value of their assets. The Commission's reasoning was:

The annual total return of a wide variety of balanced investment funds over the previous ten years was about 9 to 10 percent. Allowing for an annual rate of inflation of 2 to 3 percent, we felt that a payout of 6 to 8 percent would permit a reasonably managed foundation to maintain its size in real dollars.

It was the Commission's position, therefore, that "the only correct yardstick for measuring investment performance is the total rate of return."

The final result was not totally in accord with the Commission's recommendation. The distribution rules of section 4942 require a foundation to spend the greater of 6 percent of the fair market value of its portfolio or all of

its adjusted net income, excluding long-term capital gains, on an annual basis. A definition of income that excludes long-term capital gains represents a distortion of the central intent of this provision, because "the income test will tend to cause foundations to invest in growth stocks or other appreciating assets in order to receive return in a form which is not 'income.'"

Another problem concerning the distribution requirements involves the criteria for changing the 6 percent standard from time to time. Code section 4942(e)(3) sets forth the rule that the percentage distribution requirement for any taxable year beginning after 1970 shall bear a relationship to 6 percent which is comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to money rates and investment yields for the calendar year 1969. The regulations should relate changes in the percentage distribution requirement to a standard which will insure substantial philanthropic distributions but at the same time will not fluctuate widely from year to year.

3. Lobbying and political activity

The rules relating to lobbying, political activities and grant-making by foundations, coupled with the penalties under section 4945, seem on their face to inhibit foundations from participating in many fields of social

concern and human endeavor. For example, section 4945(e) prohibits a private foundation from making "any attempt to influence any legislation through an attempt to affect the opinion of the general public or any segment thereof, . . . other than through making available the results of nonpartisan analysis, study, or research." The prohibition against an attempt to affect public opinion, rigidly construed, might allow no room for the continuance of constructive work by foundations in the fields of population control, ecology, the arts, public broadcasting, and the administration of justice, to name but a few.

However, in this area as in others relating to program activities of foundations, the regulations have interpreted the statute liberally, construing "nonpartisan analysis, study, or research" to permit "examinations and discussions of broad social, economic, and similar problems . . . even if the problems are of the type with which government would be expected to deal ultimately." The regulations proceed to state as follows:

Thus, the term "any attempt to influence any legislation" does not include public discussion, or communications with members of legislative bodies or governmental employees, the general subject of which is also the subject of legislation before a

legislative body, so long as such discussion does not address itself to the merits of a specific legislative proposal.

Another ameliorative provision permits a private foundation to appear before, or communicate with, any legislative body with respect to a possible decision of such body which might affect the existence of the foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to the foundation. Thus, had this provision been in existence before 1969, it would have been clear that foundations could have testified for or against the Tax Reform Act provisions affecting them which were eventually enacted that year. The final Treasury regulations make it clear that a foundation may initiate legislation of this type by communicating with a legislative body without first receiving a request from the legislative body to do so.

The problems presented by the statute and its lack of clarity compound the fact that the penalties on foundations and managers are seemingly harsh, because the foundations and managers are deterred from acting in the gray areas where the rules are unclear. However, as illustrated above, the final Treasury regulations have considerably alleviated this deterrent effect by eliminating much of the lack of clarity.

4. Liability to state penalties

There is one further area of potential prob-

lems confronting foundation managers. Regardless of whether a foundation or its manager is subjected to taxes or penalties under the Internal Revenue Code as a result of a particular transaction, the scope of the manager's liability under state law is unclear. Such liability varies from state to state, and there is very little developed authority at this time after only about four years of experience under the Tax Reform Act of 1969. In any event, depending upon the state in which the foundation is located and the transaction occurred, state law may be yet another inhibiting factor with respect to the foundation's creative instincts and natural areas of concern.

III. EFFECT OF TAX REFORM ACT OF 1969
ON BIRTH RATE AND MORTALITY RATE
OF PRIVATE FOUNDATIONS

At the present time, an analysis of whether there has been a decline or increase in the birth rate of foundations may be premature, as the Tax Reform Act provisions have taken effect in the too recent past. However, some speculation has already been advanced to demonstrate that foundations are terminating in greater numbers than before the Tax Reform Act and that fewer foundations are being formed since the Tax Reform Act.

The reporting provisions and restrictions on foundations enacted in 1969 have probably made it uneconomical for many very small foundations to continue their operations.

Thus, there has probably been an initial surge of foundation terminations which will not continue beyond the next few years and which is not an indication of a permanent trend. Many small foundations, instead of terminating by distributing all of their net assets, have become affiliated with community foundations or other public charities or have qualified as pass-through organizations. Other small foundations have developed economies of scale by engaging with one another in various types of joint service arrangements.

The Commission on Foundations and Private Philanthropy stated in 1969 that "contributions to grant-making foundations in the future will be discouraged by provisions in the tax law--this because the provisions make contributions to a grant-making foundation a less attractive prospect for a wealthy individual than it has been in the past." It is true that the Tax Reform Act has provided less incentive for contributions of appreciated property to private foundations, and the limitation on foundation ownership of business enterprises appears greater than necessary in order to insure that the donor will not use his foundation to maintain control of his company. However, the foundation community seems to be living quite well under the Tax Reform Act restrictions as interpreted by the Treasury regulations, and the volume of complaints about the private foundation provisions has considerably subsided in the past two years.

The Commission evaluates the 1969 Act as a mixture of blessings and burdens, with blessings predominant. The report strongly endorses the self-dealing, income distribution, reporting, and foundation manager penalty provisions. It criticizes the 4 percent tax, the business divestiture rule, and the imposition of taxes upon the assets of the foundation. However, the report itself recognizes that charity often suffers when foundation assets consist of stock with voting control over a business enterprise, and there are exceptions in the Act to many of the private foundation provisions which meet some of the Commission's concerns.

The future birth rate of foundations will also be affected by whether the private foundation rules introduced in the 1969 Act will be extended by additional legislation to encompass public charities as well. Although some changes affecting public charities may be merited, neither Congress nor the Treasury Department has apparently reached any final conclusions as yet. As a general rule, the discipline of public support has proved to be an adequate restraint on the activities of public charities. There is no clear need for such specific rules as the self-dealing, income payout, business divestiture, and taxable expenditure rules as are present in sections 4941 through 4945 for private foundations. The condition arising at law generally that the public charity's property be devoted to charitable use will ordinarily be sufficient.

The principal concern with respect to public charities, as for private foundations before the 1969 Act, is the inflexibility of the present sanctions and the consequence of loss of exempt status. The loss of exempt status is not an appropriate sanction because it does not enforce the charitable use, on the basis of which the deduction for charitable contributions and the exempt status of the organization were previously allowed. It seems more appropriate, as was done by section 509(b) in the case of private foundations, by some means to lock all section 501(c)(3) organizations into charitable status. Similarly, it would be desirable to permit small violations of the charitable use condition to be dealt with by a lesser penalty than denial of exempt status. The net effect would be that an organization, once determined to be legally organized as a charity for federal tax purposes, could not thereafter escape the requirements of federal law regarding administration of its assets for charitable purposes. In this manner, too, there would be a substantially reduced incentive for private foundations to convert to public charity status or otherwise to terminate in order to escape the private foundation restrictions of the 1969 Act.

IV. EQUITABLE REMEDIES

The Treasury proposals of April 22, 1969 provided for specific sanctions for each of the substantive rules, in the form of civil penalties against errant individuals and di-

vestiture requirements against the foundation. Imposition of these specific sanctions was to be mandatory upon the finding of a violation. In addition, United States district courts were to be invested with a set of equity powers sufficient to remedy any violation of the substantive rules in such a manner as to insure no financial detriment to the foundation (including, but not limited to, power to rescind transactions, surcharge trustees, and order accountings) and to preserve the assets of the foundation for charitable purposes (including, but not limited to, power to substitute trustees, divest assets, enjoin activities and appoint receivers).

In order to give the states a substantive right to enforce the prohibitions against self-dealing, inadequate charitable distributions and improper business interests, the Treasury proposed a rule which would have conditioned the grant of exemption upon inclusion in the organization's governing instrument of provisions requiring it to comply with the statutory standards. Old organizations were to be given five years to apply for exemption with amended governing instruments. Any organization which failed to apply in such manner would have lost its exemption from the effective date of the legislation.

Equitable remedies, even as proposed by the Treasury Department in 1969, were in addition to the specific sanctions and not in lieu of them. Thus, the Treasury apparently

recognized that specific rules were necessary in order to make more certain the types of activities which would be prohibited, while equity powers in the courts would enable the sanctions to be tailored more closely to the extent and magnitude of the violations. In light of the manner in which the Treasury regulations have safeguarded foundation managers against the imposition of taxes and penalties, and in view of the liberal interpretation which the regulations have given to violations of the private foundation rules, equity powers seem less necessary now than they did before the regulations were published. Moreover, rescission of certain transactions is required under the Treasury regulations, and state officials have been involved in the enforcement process by reason of the governing instrument provisions, the procedures for correction of various transactions, and the reporting and disclosure requirements imposed upon foundations.

V. CONCLUSION

The Treasury Department seems to be relying heavily upon the cooperation of the attorneys general and the foundation community in the years following the enactment of the 1969 law. Every effort possible has apparently been made in the regulations to provide for maximum flexibility within the statutory limits, without any desire or purpose to limit the scope of proper foundation activities in any way. The regulations have developed rules which offer more certainty, are

conducive to better enforcement, and can be administered with greater assurance that they comply with Congressional intent. The rules regarding taxes and penalties on foundations and their managers seem to be both reasonable and consistent with the continued viability of philanthropic endeavors.

HEARINGS OF SUBCOMMITTEE ON FOUNDATIONSSENATE FINANCE COMMITTEESTATEMENT OF GEORGE D. WEBSTER

I want to thank the Subcommittee for providing me with this opportunity to appear before it and discuss the effects of the 1969 Tax Act on foundations.

It would be an understatement to say that the Tax Reform Act has had a substantial effect on private foundations.

The overriding effect of the Chapter 42 provisions has, of course, been much greater caution by foundations in their dealings. Examples of this are the extreme caution which is exercised in terms of making grants, both to individuals and to other foundations. It is my personal belief that this caution may not in all instances be necessary and that the provisions of Section 4941 dealing with self-dealing and the provisions under Section 4945 dealing with taxable expenditures causes undue caution by many foundations in their grant making and other activity.

With respect to the establishment of new foundations and the continuance of existing foundations, it appears to us that there is a diminishing number of new private foundations being established. In many instances, this is not an adverse effect in view of the fact that it has prevented many of the very small foundations with assets of between ten and two-hundred thousand dollars from being formed. With the problems of the pay-out requirements and other restrictions, it is simply not feasible in many instances to establish such foundations but rather the assets can be channeled to existing comparable organizations.

In terms of the continuance of existing foundations, there have been a number of foundations which have been terminated of which we are aware. To the extent that the foundations have not been terminated,

we have noted that there have been a number of them which have been changed to qualify as Section 509(a)(3) support organizations. That is, control of these foundations has been vested in public foundations. This has placed a great deal of pressure on Section 509(a)(3) and in terms of suggested changes in the law, it would appear that in addition to the present language of Section 509(a)(3), there should be some additional provision made for foundations which, while they are not controlled by public foundations, are required to distribute all of their income to public organizations. Specifically, it is suggested that in instances in which there is this requirement, that foundations be exempted from the 4% taxable investment income, in fact it is the 4% taxable investment income which has, in many instances, forced foundations to make the change to come within Section 509(a)(3). The pay-out requirement has also created a great deal of pressure in this direction, and this is primarily because the requirement of the pay-out provision - 6% of assets - is certainly too high and very few foundations at the present time are able to achieve a 6% return on their investment. They are simply not in the business of being in business. In effect, by the requirement that they pay out 6% of their assets, the provision has the effect of forcing the foundation to give additional consideration to its investment policy as opposed to its charitable activities. This unintended result should not be forced by the very strict pay-out requirement.

I have alluded earlier to the audit fee tax and suggested one instance in which it could be eliminated in the case of trusts or other organizations which are required to distribute all of their income to public foundations. However, it is my opinion that the 4% investment income tax should be reduced to not more than 2%, and further that the audit fee should be channeled to the Exempt Organizations Branch of the

Internal Revenue Service so that it will be in a position to improve its audit techniques and otherwise improve the services which should be available to private foundations for rulings and other transactions. If the law is to continue with respect to private foundations in its present strict manner, then foundations should be in a position to inquire of the Service concerning the effect of prospective transactions. Further, when they inquire, there should be competent persons who have been fully trained who can respond to their inquiries in the form of rulings. In my opinion, most of the individuals in the National Office of the Internal Revenue Service Exempt Organizations Branch are extremely competent and they are, in many instances, limited by staff requirements and are not in a position to give as full attention to many issues which present themselves as they would like. However, in terms of the field personnel of the Internal Revenue Service District Directors' offices, it is difficult to generalize. It has been my experience in many instances that many of these individuals have not been properly trained not only in the private foundation area, but also in other areas of exempt organizations. Thus, the points that they raise are in many instances not real problems, and they unduly prolong audits because of their failure to reach intelligible decisions.

In terms of changes which could be made in the present law, I have alluded to several including a proposed change in Section 509(a)(3) and also a change with respect to the 4% tax on mandatory pay-out trusts. Also, it would seem that any charitable organization which is controlled by membership organizations should be treated as other than a private foundation. Thus, the last sentence of Section 509(a) should be changed to add other sections in addition to those referred to, which are Section 501(c)(4), (5) and (6).

Another problem for many organizations, particularly orphanages

and old-age homes, is that they have been in existence for many years and already have their fixed plants. They, however, get no credit for this in terms of the pay-out requirement, and it has been difficult for many of these organizations to meet the pay-out requirement of the statute. Further, of course, there is the question of whether these organizations should even be treated as private foundations, in any event. It seems, in our opinion, that they should be treated as hospitals and educational organizations, with independent status as other than private foundations.

The provisions of Section 507, which at the present time provide that private foundation status can only be terminated over a five-year period should, in my opinion, be changed to permit a termination over a period of not more than two years. The five-year period is unduly long for an organization to have to wait for a final determination of its termination and fruitful operation as a public charitable organization. Two years should be more than sufficient to establish that it is now a public foundation.

In terms of reporting by exempt organizations, I have always been an advocate that exempt organizations should be required to fully report their activities to the public. By so reporting their activities they, of course, dispel from the public mind the notion that they in some way act other than in the public interest. Also for those which may wish to act other than in the public interest, reporting will force them to change their ways or face public pressure. Also, from a technical standpoint, it does not seem necessary to separate the two sections of the Code's requirements concerning reports by private foundations and those of other organizations which are exempt. In this connection, if information is to be made public by the Internal Revenue Service with respect to all exempt organizations as is required by Section 6104, it does not

seem that it would be unreasonable to require that all exempt organizations make available this information to the public as private foundations are apparently required to do.

With respect to the reporting requirements, it is suggested that foundations be required to report salary levels of their officers and directors and division heads.

Before Subcommittee on Foundations
Committee on Finance
United States Senate
October 2, 1973

Testimony of: Sheldon S. Cohen
Cohen and Uretz
1730 M Street, N. W.
Washington, D. C. 20036

Suggestions for changes in system of administering Charitable Organizations (Philanthropy).

Outline

- (1) I appreciate the opportunity to share my ideas and thoughts with the Subcommittee as it goes about these constructive sessions of becoming oriented in this complex and important area.
- (2) Outline:
 - I. The U.S. has a very complex system of Federal and State law governing tax exempt organizations.
 - A. They are creatures created by state law.
 - B. They are answerable to complex state and Federal statutory schemes. (Described earlier by Mrs. Freemont-Smith.)
 - C. Both state and Federal law inadequately enforced -- spotty in some areas, very good in others, but generally deficient. Of course, since the 1969 Act, the area of Foundations has been more adequately covered than any other. I believe Congress should give similar attention to other areas.
 - D. Your Subcommittee is assigned only to Foundations. This is only one very small subdivision of section 501(c)(3). As you know,

there is a list of over 20 areas of tax exemption in Subchapter F of Chapter I of the Internal Revenue Code.

II. Deficiencies in existing law.

- A. The statute uses particular names as description rather than discussing permissible sources and uses of money.
- B. The present exemption provisions are in large part adopted from the Corporation Excise Act of 1909 and are thus over 60 years old. The area has been substantially neglected for many years other than the Congress' preoccupation with Foundations. The world has substantially changed since 1909.
- C. The language of the Code is vague.
- D. The Sanctions in all areas are either inadequate, ineffective or punitive rather than corrective.
- E. Again, the attention given in 1969 was solely to Foundations. Hence, the remainder of the tax exempt area cries for attention.

III. The Internal Revenue Service's role.

- A. Large and complex organizations.
 - 1. Staff of approximately 75,000: National Office staff about 5,000, the remaining in 7 Regional offices, 58 District offices and about 700 to 800 suboffices.
 - 2. Budget of approximately \$1,200,000,000.
 - 3. Revenue collected last year approximately \$210 billion (fiscal 1973).
 - 4. Current year approximately \$260 billion (fiscal 1974).

5. Returns estimated 117 million.
 6. Revenue from audits, \$3.2 billion.
 7. Total enforcement revenue in checks, audit, collection, verification, etc., \$6.6 billion.
 8. Audits of about two million returns.
- B. From above it is clear that the administration of exempt organizations is a stepchild.
1. Exemption applications and audits are centralized in about 16 District offices. About 500 agents have some experience in exempt organization work.
 2. Rulings are handled in National Office by Assistant Commissioner (Technical). Exempt Organization Branch of Miscellaneous and Special Provision Tax Division handles both ruling requests and advises field on technical aspects of law as well as being the place where hearings are held on evaluation of exemption.
- C. In my opinion, Tax Exempt Organizations will always be considered as a stepchild in an organization whose major role is tax collection. Most people in the Service do not see the administration of the tax exemption laws -- as important as they may be -- to have anything like the importance of tax collection and administration. Thus, although the Assistant Commissioner Technical has a major role in the tax exempt area his time spent in the area is minor and of course, the same is true to a greater degree for the Commissioner of Internal Revenue and the Secretary of Treasury.

- D. Suggestion in new Pension Reform Bill for new Assistant Commissioner who will be responsible for pension trusts and exempt organizations.
1. In my opinion, this is some change, not a major improvement. The Service's role is still that of a tax collection agency. The way up the promotion ladder will still, I suspect, be in the eyes of the Service staff, through the audit or collection route.
 2. The type of person recruited will still be primarily accountants whose role in the philosophical areas of tax exemption is rather limited. I expect that those with broad socialological, scientific, philosophical and other broad backgrounds will not seek positions with the IRS -- even with the new Assistant Commissioner for Pension and Exempt Organizations. I do not mean that this change is not an improvement -- I think that it may be -- but I think we need to go further.
 3. Therefore, after Ditchley, a small group met for a number of months to attempt to design a better administration system. Our ideas came from the Peterson Commission Report, Foundations, Private Giving and Public Policy, Report and Recommendation of the Commissioner on Foundations and Private Philanthropy, University of Chicago Press (1970) and the Ditchley Conference of April, 1972, Philanthropy in the '70's: An Anglo-American Discussion, edited by John J. Corson and Harry V. Hudson, The Council on Foundations, Inc. (1973).

4. The group was composed of:
 - a. Alan Pifer, President of Carnegie Foundation
 - b. J. Kellum Smith, Jr., - Secretary of the Rockefeller Foundation
 - c. Stanley S. Surrey - Former Assistant Secretary of Treasury and Professor at Harvard Law School
 - d. Walter Blum - Professor of Law, University of Chicago Law School
 - e. David Freeman - President, Council on Foundations
 - f. Marion Freemont-Smith, Attorney in Boston, author of several books on Foundations
 - g. John Nolan - Former Deputy Assistant Secretary of Treasury and Attorney in Washington, D.C.
 - h. John Simon - Professor of Law, Yale, Foundation Executive
 - i. Thomas Troyer - Attorney in Washington, D.C., Former Treasury Official
 - j. John Corson - Consultant to Carnegie Foundation, Management Consultant, Fry Consultants, Inc., Former Government official
 - k. Sheldon S. Cohen
5. From this group came the idea of a separate administrative organization for 501(c)(3) organizations. (I should add that the ideas I will outline may not be concurred in by all of the above per-

sons, but resulted from discussions among the group. The principle drafts of the ideas were Mr. Troyer's and Mr. Nolan's.)

- a. National Commission on Philanthropy
 - (1) Independent, modeled after SEC
 - (ii) Members appointed by President and confirmed by Senate

- b. Role - Promoting, encouraging and advancing private philanthropy in U.S. Annual Report to Congress on the status of private charities in our country.

- c. Responsible for section 501(c)(3) organizations. Remainder of tax exempt areas to remain with the IRS.
 - (1) Both audit and ruling function
 - (ii) Determination of Commission conclusive with IRS. IRS would continue role in unrelated business income.
 - (iii) Right of prompt appeal to court for adverse rulings.

- d. Cooperation with States.

- e. Appropriate audit fees -- if necessary. [Note: at present only foundations of all 501 exempt organizations pay excise tax which covers continuation of audit, rulings and all other IRS functions, for all exempt organizations -- from business leagues and chambers of commerce to labor unions, and social clubs. This does seem a little odd.]

Testimony Before Sub-Committee on
Foundations of Senate Finance
Committee. October 2, 1973

by

Marion R. Fremont-Smith, Attorney
Partner, Choate, Hall & Stewart
Boston, Massachusetts

Mr. Chairman, members of the Sub-Committee, as Mr. Pifer explained, I will attempt to describe briefly the English System for supervision of charities and distinguish those aspects which differ from our own.

The roots of our charity law, both state and federal, are to be found in the English common law. In fact, the enumeration of exempt purposes appearing in the Income Tax Regulations under Section 501(c)(3) follows almost verbatim the list of charitable purposes set forth in the Statute of Charitable Uses of 1601 wherein Parliament for the first time attempted to codify those purposes that were regarded as charitable under English law and that still form the basis of the English Law of Charity.

That same Act also established a system for the supervision of charitable organizations that remains in effect today in England. It has three basic elements:

1. Enforcement of charitable trusts as a secular matter by the Court of Chancery.

2. Protection of charitable trusts by the Sovereign in his role as *parens patriae* protecting those who cannot protect themselves. This includes minors, lunatics and charitable organizations.
3. Delegation by the Sovereign to a group of individuals, the Charity Commissioners, of the immediate duty of supervision of the management of charitable funds, thereby giving charities an easily accessible place to obtain advice and counsel and relieving them of expensive and time-consuming court proceedings.

The present Charity Commissioners derive their powers and duties from legislation enacted in 1960 following an extensive study by a special committee created by Parliament ten years earlier, shortly after the Labor Government took office. The committee was established to answer the basic question then faced by the government, namely, whether there was a place for private charity in the welfare state, or whether government should be the sole provider of all those services to the community theretofore provided by charitable institutions. The Nathan Commission, as this special committee came to be known, strongly affirmed the values of private philanthropy and then set about devising means for encouraging charity and, at the same time, assuring responsibility and accountability in its management. In the area of

supervision they recommended continuation of the Charity Commission, but with increased powers and enlarged duties, and with a voice in government sufficient to assure it adequate funding and a vehicle for placing its legislative recommendations before Parliament.

The recital of the functions of the Commissioners set forth in the Charities Act of 1960 gives the best clue to their method of operation. The Commissioners are charged with "promoting the effective use of charitable resources by encouraging the development of better methods of administration, by giving charity trustees information or advice on any matters affecting the charity, and, by investigating and checking abuses." The Commissioners are specifically prohibited, however, from acting "in the administration of the charity" or, in other words, second guessing trustees in their day to day operation.

The Charity Commission is composed of three individuals appointed by the Home Secretary. All of them must be public servants, and two of them must be members of the bar. They operate with a staff of approximately two hundred in London and one hundred in Liverpool, overseeing the activities of some 77,000 charitable organizations.

A former chief Charity Commissioner, Christopher P. Hill, has listed the duties of the Commissioners under four headings

which illustrate the wide range of their specific powers.¹

The first of these he refers to as "advisory", both on general and legal matters. Trustees acting on the Commissioners' advice will be deemed to be acting in accordance with their trust and protected if called upon to account in the future. The counterpart to this power in our system is, of course, the Internal Revenue Service private ruling. However, the British system is far less formal and there are no rigid rules proscribing matters on which the Commissioners will not render advice.

A second set of powers is referred to as "supervisory". This includes the maintenance of a Registry in which all charities must be enrolled and with which they must file periodic accounts. Since the act of registration carries with it automatic exemption from taxation, this power lies at the heart of the system. The periodic accounts are scrutinized by the Commissioners' staff, which can require an independent audit where warranted. The Commissioners are also empowered to investigate alleged abuses, and if necessary, report to the Attorney General, who will bring court action to seek correction. In an emergency, the Commissioners themselves may suspend trustees

1. Christopher P. Hill, "The English System of Charity", in Philanthropy in the 70's: An Anglo-American Discussion, published by the Council on Foundations, Inc., New York, New York, 1973, pp. 61-88.

and freeze charity properties pending the outcome of court proceedings.

The third set of powers held by the Commissioners are described as "revisory", meaning that they may authorize changes in trust purposes or methods of administration prescribed by Donors, without court authorization. They also exercise the powers of a court to authorize changes in trustee personnel.

Under a fourth set of powers, described as "regulative", the Commissioners are empowered to permit deviations from fiduciary law. They may consent to mortgages or to sales of permanent endowment or functional land that would otherwise be prohibited. They may also grant trustees permission to incur legal fees and bring judicial proceedings on matters not within the power of the Commissioners to approve. Only with this permission may these costs be charged to the charity property.

This enumeration does not, however, present the true nature of the supervisory scheme. It is not primarily adversary; rather there is an assumption that the aims of individual trustees are the same as those of the Commissioners, namely, the improvement of the administration of charity. There is, thus, much room for flexibility. Problems are looked at in a positive frame of mind and it is assumed that most abuses can be corrected without resort to the punitive powers that are ultimately available to the Commissioners.

In part, this positive attitude is possible because of clearly defined limits on trustee behavior that have long been a part of the English substantive law. Self dealing is absolutely prohibited; the range of investments closely circumscribed; trustees may not borrow funds nor run non-charitable enterprises without a showing of special competence and need.

Another reason that this positive approach is possible stems from the constitutional basis for the special status of charity under British law. It starts with the constitutional principle that funds donated to charity are for the benefit of the community. I would like here to quote from Mr. Hill; ". . . since the Crown undertakes to enforce against all parties the use of the property for the public purposes chosen by the Donor, a fortiori, it will itself not divert part of capital or income by taxation to use for purposes of its own." In other words, exemption from taxation is not considered a privilege bestowed by government but an implicit duty required by government.

The system of registration, conferring as it does automatic exemption from taxation, is an essential element of the supervisory system. Furthermore, this exemption, once granted, cannot be revoked by the tax authorities. In theory the Inland Revenue can appeal a decision of the Commissioners, whether to register a charity or to remove it from the roll. In practice, the Commissioners ask the tax authorities for their views prior to making decisions and, to date, disputes have rarely

arisen between the two organizations.

This does not mean that the Inland Revenue has no dealings with charity trustees. In fact, the tax system requires submission of tax returns to it for two purposes; to obtain relief from real property taxes and to obtain refunds of taxes either withheld at the source or paid by individuals and corporations on income given to charity under a system called the "long term covenant".

There is, of course, a basic difference here between the English tax system and our own for, aside from the covenants and a limited estate tax deduction, British tax law does not offer incentives to individuals to make charitable gifts as ours does. It has been argued that the existence of deductibility is so crucial to our own system that only the Internal Revenue Service can supervise those organizations to which deductible gifts can be made. The importance of the Internal Revenue Service, however, has grown principally because there has been no other agency of Federal government that could assure proper administration of charity and it has stepped into the vacuum. Clearly, assurance of this nature is a necessary concomitant of a viable tax system, but there is no reason to assume that only the Internal Revenue Service is fitted to provide it. In fact, the British experience suggests that just the opposite may be true.

There is, of course, another major difference between

the British and American systems of government that make it impossible for Congress to merely establish an independent body and delegate to it all of the functions and powers held by the English Commissioners. I refer, of course, to the facts that each of the fifty states has an interest in the creation and dissolution of charities, that state courts have the power to correct abuses in administration, and that the Attorney General in each state has been assigned the role of enforcement exercised by his counterpart in Britain. In short, the basic elements of the British system, other than delegation of the Sovereign's powers to Charity Commissioners have been adopted in each of our states and, even though the enforcement power is effectively exercised in only a handful of them, Congress is under some constraint to recognize and accommodate the states' interest.

This is not an insuperable task. One pattern for accomplishing it is to be found in those provisions of the Tax Reform Act of 1969 permitting abatement of the termination tax on private foundations if the state has taken effective action within a given period of time to assure preservation of assets by directing their transfer to publicly supported organizations. What is missing in our Federal system, however, is those elements of the ideal system described by Mr. Pifer that are designed to encourage and nurture philanthropy; to make it easier for trustees

to function, and to assist them in their efforts to improve.

I would suggest that it is here that we can surely learn from the English experience. It should now be evident, in fact, that the ideal system that has been delineated has striking similarities to the English system. This is no accident. Mr. Pifer, Mr. Cohen and I were among a group of thirteen Americans who attended a conference on Anglo-American philanthropy in England in the spring of 1972, where we learned first-hand of the effectiveness of the British supervisory system. On our return, seven of us participated in a series of exploratory discussions with other individuals interested in the foundation field in an attempt to determine whether any elements of the British system could be adopted here.

Much of what you hear today reflects the belief of this group that basic changes in the supervision of philanthropy are desirable if we are to assure its continuing ability to play an effective role in our society. We do not pretend to have answered all of the questions posed by a proposal to establish an independent agency to supervise charitable organizations. We do feel, however, that it is an ideal toward which we should strive and we are encouraged by the fact that this Committee is willing to explore the benefits that might accrue from a different approach to supervision than we now have.

Testimony Before Sub-Committee On
Foundations of Senate Finance
Committee. October 2, 1973

by
Alan Pifer, President
Carnegie Corporation of New York

Mr. Chairman, members of the Sub-Committee, my name is Alan Pifer, and I am president of Carnegie Corporation of New York and of The Carnegie Foundation for the Advancement of Teaching. As I am to speak first, I would like to introduce my colleagues on this panel. They are: Mrs. Marion Fremont-Smith, practicing attorney in Boston, expert on the legal relationship of foundations and government, and author of two books and numerous articles; Mr. Nathaniel Spear III, International Specialist of the Foundation Center in New York, responsible for collecting information on foundations in other countries; and Mr. Sheldon Cohen, practicing attorney in Washington, and Commissioner of Internal Revenue from 1965 to 1969.

It is our intention this morning to speak about the entire field of charitable organizations, rather than simply about foundations. We are taking this approach because foundations are an integral part of charity at large and, in

our view, are inseparable from it. We do not believe that the question of governmental supervision of foundations, which we understand to be your interest in this session of the Sub-Committee's hearings, can be examined fruitfully except within the larger context of the supervision of charity.

We do not plan to deal with the many forms of tax-exempt organizations other than the charitable organizations covered by Section 501 (c) (3). As you know, Section 501 (c) of the tax code lists eighteen other categories of exempt organizations, including such diverse entities as labor unions, chambers of commerce, social clubs, mutual ditch and telephone companies, cemetery companies, credit unions, mutual insurance companies, and pension funds. The distinguishing characteristic of these entities is that they exist for the benefit of their members or of limited categories of individuals. Charitable organizations, on the other hand, exist for the general benefit of the community. This, to our way of thinking, is a fundamental difference.

There are, of course, many types of organizations and institutions included under the 501 (c) (3) charitable exemption provision of the tax code. To name just a few, there are private colleges and schools, religious organizations, voluntary hospitals, museums, organizations concerned with the arts, various welfare agencies, and both public and private foundations. As a proportion of the more than 200,000 Section 501 (c) (3) organizations, foundations probably account for no more than 15 percent, although their importance is no doubt greater than their limited numbers would suggest.

In the few minutes remaining to me, I am going to sketch out very broadly what we on the panel would consider the essential characteristics and functions of an ideal federal government arrangement for the supervision of charity. Mrs. Fremont-Smith will then describe the British system, including the Charities Commission, followed by Mr. Spear, who will talk about the situation in several other countries. Lastly, Mr. Cohen will discuss the question of the desirable location of the

supervisory function within the federal establishment and, specifically, the pros and cons of having it within the Internal Revenue Service, elsewhere within the Treasury, or in a totally independent position.

Ideally, any mechanism, or center, for the supervision of charity in this country at the national level should have the following broad characteristics:

1. The center should be concerned only with the field of charity and not with other forms of tax-exempt organizations.
2. The center should rest on the assumption that charity exists for the benefit of the community, and the public interest is as much served by it as by governmental action. The essential purpose of supervision, therefore, is affirmative - to protect, strengthen, and encourage charity and build public confidence in it. Sanctions applied to prevent abuse should, it follows, be designed so as not to deplete charity itself, as this would by definition be contrary to the public interest.

3. The center should recognize that the states have many basic powers and responsibilities in regard to charity. Therefore, it should be the center's duty to develop means to cooperate with state authorities in furtherance of joint federal and state objectives.
4. The center should be non-partisan, objective, fair-minded, and independent in its operations.
5. The center should be manned both at policy and staff levels, by well-trained individuals with the necessary educational background and experience to deal competently with the needs and problems of the charitable field.

A supervisory center with these broad characteristics would perform a number of important functions. The principal ones are as follows:

1. The center would have the power to determine what is charitable and to grant or deny tax exemption accordingly, although this power might be limited by a right of appeal to the courts.

2. The center would maintain a publicly available register. Listing in this register would be an organization's guarantee that it enjoyed tax-exempt, charitable status.
3. The center would conduct audits of the operations of tax-exempt, charitable organizations.
4. The center would have the duty to see to it that the legal standards applying to charity were enforced.
5. The center would, when requested, give advisory opinions with respect to the legal consequences of proposed actions by charitable organizations.
6. The center would gather data about all aspects of charity, would issue publications periodically, and would provide information to the public on request.
7. The center would advise Congress and the executive branch of government on charitable matters.

Mr. Chairman, I have spelled out the broad characteristics and general functions of a center for the supervision of charity. It is my belief that we have never, in this country, had anything which approximated such a center. Further, it is my belief that the growing pressure on private institutions makes the establishment of such a center imperative. The day has come when government must encourage charity in every way it can, if the American system is to continue to embrace the traditional and well-proven concept of private initiative for the public good, for that concept is embodied in charity and given expression by it. I greatly hope that the Congress will give this urgent task high priority.

AP:ap
September 27, 1973

Testimony Before Sub-Committee On
Foundations of Senate Finance
Committee. October 2, 1973

by

Nathaniel Spear III, International Specialist
The Foundation Center

Mr. Chairman, members of the Sub-Committee, brevity and relevance dictate that I confine my remarks on the supervision of philanthropy outside of the United States (excluding the United Kingdom) to a brief outline of the situation around the world where, either through tradition or current activity, systems of organized distribution of private wealth for public welfare exist. I have been privileged to observe at close range and report on the indigenous application of the philanthropic foundation model which, though relatively recent in history, is a worldwide phenomenon. Nevertheless, in consideration of its often limited function within the overall context of many countries' charities and its frequent service to society's needs without a tax-incentive factor, official surveillance is, generally, minimal; similarly, I have discovered that religious, humanitarian, and personal motivations to achieve posterity through charity vie very favorably with tax-incentives, thereby obviating close scrutiny. The widespread absence of registries, coupled with inadequate or non-existent statutory mechanisms for the supervision of charitable organizations, are major drawbacks. Public accountability is rarely in evidence. Perhaps, an institution like the modern, U.S.-type foundation, grounded in Anglo-Saxon law, becomes too unwieldy an instrument for those nations whose legal systems do not possess the essential apparatus to super-

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vise its activities and encourage its expression.

In Australia, where there are as yet no statutes requiring charitable trusts or foundations to be registered either at the federal or state level, a long-standing schism and rivalry between Government and state powers has hampered philanthropic development. Recently, however, the Commissioner of Taxation, who is empowered to grant exemptions for charitable donations, has shown a more liberal attitude toward charity. As a result of a 1971 Conference of Philanthropic Trusts in Melbourne, sponsored by 2 leading, grant-making foundations and supported by many in Australia and New Zealand, efforts are underway to seek uniform legislation in this area, especially directed toward the attorneys-general, who administer charitable collections and trusts. The still prevalent climate of secrecy among foundations, their failure to communicate and possibly collaborate (resulting in duplicative efforts and neglected priorities), together with the absence of any agency for the gathering, assimilation, and study of philanthropic data, continue to hinder the growth of charity. However, pressures are mounting to persuade private and corporate charities to provide public disclosure.

Since a correlation often exists between economic strength and charitable activity, it is not surprising that Japan commands our attention. Notwithstanding the immense potential of its estimated 10,000 foundations, supervised by 12 Ministries and numerous prefectural governors, a reluctance by the Ministry of Finance to grant tax-exemption has up to now stunted their development, particularly those in the corporate sector. Furthermore, no accurate tabulations have been made of their resources, purposes, and concomitant impact upon society. Individual and unified efforts by the business community to commit huge financial profits for social progress appear to be stymied unless the Government passes legislation in order to alleviate heavy tax burdens.

On a more positive and encouraging note, most Asian countries have laws permitting the deduction of charitable gifts prior to the computation of income tax. Throughout most of Southeast Asia a personalized, rather than organizational, approach to philanthropy is the dominant pattern; hence, efforts to investigate and arrive at reliable statistics in the compilation of, for instance, the munificence of the many overseas Chinese communities in Thailand, Singapore, and Malaysia, are fraught with frustration. With few exceptions, isolated examples of foundations are administered unprofessionally and, as a rule, reflect the wishes of the donor: thus, the specter of control by a "dead hand" rises and plagues many Asian countries. As early as the 7th century, the Mohammedan waqf, a religious equivalent of the foundation or charitable trust under English common law, was formed and survives today in the Moslem world. Several 100,000 of these philanthropic entities extend from India and Pakistan to Iran, Turkey, and the Arab countries. These religious endowments comprising gifts and bequests from individual sources are administered by Councils of private citizens, presided over by a Ministry, which in turn controls a vast complex of religious, educational, and social welfare institutions. If methods could be devised to harness and consolidate these trusts in a manner similar to U.S. community trusts, their contribution to the public good would be formidable.

In Europe, where the definition, legal status, and fiscal treatment of charities differ widely from country to country, so, too, the mechanisms that supervise them. Until the 1960's most European countries evinced little interest in charitable institutions, but in the last decade enormous strides have been taken to codify data. In Germany, the unquestioned leader in the foundation field, the problem of supervision is at a virtual standstill because of its 4,000-odd foundations, 3,000 are established under private law, and, as such, have no

legal status and are not subject to governmental supervision. The remaining 1,000 under public law are registered and supervised, but their activities are comparatively insignificant and regionally circumscribed. Until the emergence of the Fritz Thyssen and Volkswagenwerk Foundations public good was regarded as a function of State. Today, however, members of government sit on the boards of many foundations and comparable institutions known as "limited liability companies", thereby often removing the need for supervision. The principal impediments, however, toward a more efficient supervisory system lie in the fragmentation of the laws and the lack of official registries.

In Switzerland, which has about 20,000 foundations, the purpose and locale of a foundation determines the agency under whose authority it falls after inscription in a registry; therefore, a myriad number of supervisory agencies, ranging from the Federal government to cantons, districts, and local associations are involved. Once notified, the competent agency maintains a continuous supervision of the foundation, and, in the event of filed complaints, undertakes an investigation. Although, as in Germany, a foundation may lack legal status, its performance is closely observed. A diametrically opposed situation prevails in the Netherlands, where there are nearly 30,000 voluntarily registered foundations, and, perhaps, an additional 15,000 more non-registered ones. In the case of incomplete or incorrect entries, a District Court may intervene, but since neither a foundation's financial statement nor its activities must be reported, the judiciary's role is restricted to internal problems of a foundation. As elsewhere in Europe, there is little concern for public accountability, as evidenced by the limited dissemination of reports.

In Latin-America, the legal status of foundations and their attendant supervision presents an ever more diversified situation, although full or partial tax-

deductions are allowed in every country except Bolivia. Opposition to organized philanthropy stems from the historical excesses of ecclesiastical power, but the modern fundación and fundaçãõ are readily accorded tax-exemption, though, without any provision for such an institution in Latin-American civil law, its status varies markedly from country to country. Venezuela is the foremost representative of private and corporate initiative for the public good yet, as in the other republics, the machinery for supervision is time-consuming, and inefficient; in fact, the State's administrative costs exceed the tax revenue produced.

The Canadian experience in charity, while distinctly individualistic, reflects a hybridization of both England and the United States in its tax provisions. As my co-panelist noted in her book, Foundations and Government, "as in the United States, supervision of charities in Canada is the responsibility of the provincial courts and legislatures". Every foundation must apply for a number automatically giving it tax-exemption through the Department of National Revenue. Although a foundation may choose between Federal and provincial registration, the latter course is more economical. Most foundations are active only within their respective provinces, but if in more than one province, they are required to apply for a letter of incorporation at the Department of Consumer and Corporate Affairs. The majority of Canada's 1,400 grant-making foundations (the top 15 have approximately \$700,000,000 in assets) are located in Ontario and Quebec, principally in Toronto and Montreal.

In accordance with the Charities Accounting Act, enacted in 1915 and amended in 1951 to include corporate philanthropy, all charities must be registered in the office of the Public Trustee. Besides keeping a strict accounting, the Public Trustee, appointed by the lieutenant governor, is vested with some of the common law jurisdiction of the Attorney General (the Crown's representative and protector of charitable property), and, should an executor or trustee fail to submit trust

information as required under the Act, the Trustee may demand that an audit be made by the Surrogate Court. Theoretically, foundations must pass their accounts through the Court at least every 3 years, but this practice is not adhered to; even when done, the method of accounting is complicated and costly. In addition, income-tax documents are poorly designed for purposes of enforcement, and the Department of National Revenue in Ottawa has heretofore shown a limited interest in the philanthropic sphere. Deficiencies in registration, irregular reporting, and a lack of public accountability argue strongly for the establishment of a separate, supervisory agency. Canada manifests a current, increasing awareness and examination of U.S. legislation vis-à-vis charity.

In conclusion, it appears on the evidence presented that, on the whole, most countries with systems of organized private charity for the public good have a modicum of success in grappling with the issue of supervision. We may have little to learn from their experience, but we should continue to seek means of fostering charity via useful dialogues beyond our shores.