The Work of Operating Foundations Strategies – Instruments – Perspectives

Bertelsmann Foundation (ed.)

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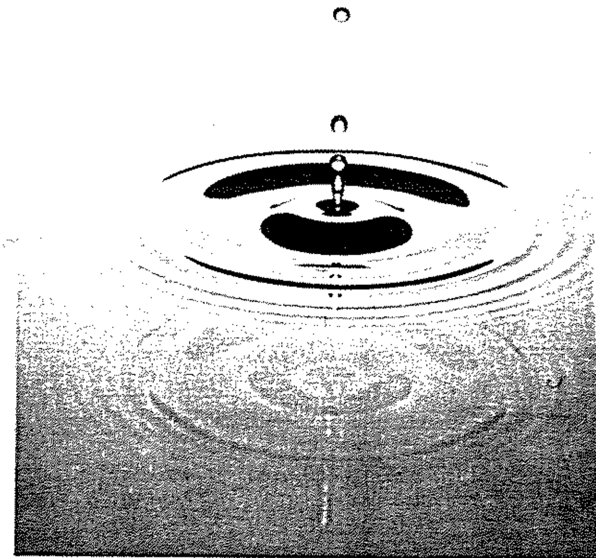

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International experiences

U.S. law affecting foundations and their ownership of businesses

Harvey P. Dale

Introduction

I was asked to focus on the U.S. experience with foundations and I want to make three preliminary observations.

First, I was instructed to concentrate on the U.S. law. Because there is no good reason to suppose that any other civilized nation would want to use the U.S. law in this area as a model for its own regime, I want to make clear that these remarks should not be understood to contain any recommendation for legal action by any government. My comments are intended to help creators and operators of foundations to consider how best to structure the governance of their foundations and particularly the ownership by their foundations of business enterprises.

Second, the U.S. law is extremely technical and largely contained, for historical reasons, in our tax law, the Internal Revenue Code (I.R.C.) of 1986. I will avoid most of those technicalities and make very few references to the U.S. tax law.

Third, I will spotlight certain governance and structural issues, and the possible policy reasons affecting them. Thus, this is *not* an overview of U.S. law affecting foundations, but rather a narrow focus on a limited portion of that law – the portion dealing with foundation ownership of business enterprises. The excess business holdings rules, discussed in this outline, are not the only ones

which may affect the ownership of a business by a private foundation. Several other rules, enacted in 1969, may also operate, depending upon the particular facts and circumstances.

I will first provide a brief historical overview of the U.S. situation. Second, I will discuss the policy reasons that led to the adoption of the U.S. rules. Third, I will mention a few examples of interesting private foundation structures involving business holdings. Finally, I will offer a few concluding remarks.

Brief history of the development of the relevant U.S. law

Although there were some few earlier instances of U.S. Congressional interest in private foundations, Congressional concern began to increase in 1961 when Representative Wright Patman of Texas called for hearings on possible abuses. For a decade, starting in 1962, he held hearings and issued eight installments of a report on foundations. This report was quite critical of the activities of private foundations. Among the "abuses" that he identified (abuses from his point of view) was the ownership of operating businesses by charitable foundations. Rep. Patman suggested that foundations be prevented from owning more than 3 percent of the stock of any business enterprise.

In 1965, during the process of the Patman hearings and in response to congressional requests, the U.S. Treasury Department issued a Report on Private Foundations. It, too, found reasons for concerns about private foundation ownership of businesses and recommended prohibiting private foundations from owning more than 20 percent of any unrelated business.

In February 1969 the U.S. House of Representatives began hearings on tax reform. Congress responded to the concerns expressed by Rep. Patman and the U.S. Treasury by passing the Tax Reform Act of 1969. This legislation added to the Internal Revenue Code, our tax law, an entire new chapter – about 28 pages of statutory language, later elaborated upon in over 150

pages of regulations – aimed at regulating the activities of private foundations. Among the rules adopted was one limiting the amount of stock that a private foundation could own in any business enterprise.

Ignoring a great many details these are its principal features:

1. I.R.C. § 4943 is captioned, "Taxes on Excess Business Holdings." It first imposes a 5 percent tax on the value of any such holdings and then – if the prohibited holdings are not disposed of in a timely manner – it imposes a second 200 percent tax on the value of such holdings.
2. The prohibited business holdings do not include two important exceptions:
   a. a functionally related business, which contemplates, e. g., tuition received by a university or medical fees received by a hospital, or
   b. a passive holding company deriving 95 percent of its income in the form of interest, dividends, royalties, capital gains, etc.
3. In general, a private foundation has a five-year period within which to dispose of its "excess business holdings" received by gift (that does not include excess business holdings purchased by it; those must be disposed of right away). That five-year period may be extended for an additional five years, with the consent of the Internal Revenue Service, if – despite diligent efforts to dispose of the holdings – the foundation can prove that it was impossible to sell them except at a substantially below-fair-market value.
4. "Excess business holdings" is defined to mean the ownership by a private foundation of voting stock of a business in excess of 20 percent of the total voting stock. The 20 percent threshold is reduced, however, by any voting stock owned by so-called "disqualified persons," which includes substantial contributors to the foundation and any foundation managers. Thus, for example, if a major contributor to the private foundation owns 15 percent of the voting stock of the business, the private

foundation's ownership of that business cannot exceed 5 percent. In certain instances, however, the 20 percent limit may be increased to 35 percent.
5. If "disqualified persons" do not own more than 20 percent of the voting stock, then (but only then) the foundation may hold non-voting stock of the business without limitation. Otherwise any non-voting stock is also included as "excess business holdings" and must be disposed of.
6. There are complex rules which treat "disqualified persons" as directly owning stock of the business which is in fact owned by corporations, partnerships, trusts, and other entities in which the disqualified persons have some interest.

This description, and these rules, apply only to private foundations. There are no equivalent proscriptions for public charities. The definition of a private foundation is very important and unfortunately very complex. In general, however, a private foundation is a grantmaking charity which has received its funding and assets from a small group of people rather than from the general public. Certain types of charities, e. g., schools, hospitals, and churches, are public charities and not private foundations, regardless of the source of their funding.

Policy concerns

Now, I will attempt to state the various policy concerns which have been expressed as reasons for worrying about charitable foundations owning too much of an operating business, and which gave rise to this legislation. Most of these considerations emerged during the Patman hearings, the 1965 Treasury Report, and the 1969 legislative process leading up to the enactment of the Tax Reform Act of 1969.

Each concern could be analyzed and criticized – indeed, there are quite strong reasons why some of the stated concerns are, in my view, either wrong or overstated – but my purpose here is

simply to put them on the table so they can be understood. Either alone or together, and despite their weaknesses, they persuaded the U.S. Congress and President in 1969 that legislative prohibitions were desirable, and they continue to be sufficiently persuasive to prevent repeal or diminution of the sanctions enacted more than 25 years ago. I have grouped the concerns under ten headings:

1. *Deferral of charitable benefits (or giving)*
The concern was that private foundations either might not receive adequate income from the businesses they control to enable them to sustain a vigorous grantmaking or charitable program, or that they might receive enough income but hold it rather than devoting it quickly to charitable causes. Evidence was presented suggesting that charities tended to receive less income from controlled businesses than from equivalent market portfolios.

2. *Unfair competition with for-profit businesses*
The concern was that charities owning a business could deploy the charitable capital for business purposes as needed, while at other times holding it and investing it free of tax. For-profit businesses, not owned by charities, would either have to pay tax on the income of their own capital resources, or compete for needed capital in the capital markets.

3. *Conflicts of interest between business and charity*
The concern was that the interests of the charitable owner might conflict with that of those running the business. For example, the charity might wish to have a high level of dividends, while the business might want to retain capital, or the business might wish to make a high-risk investment in a promising new market while the charity might prefer caution and preservation of current business values.

4. *Self-dealing*
The concern was that there are numerous ways in which people controlling the charity and the business might obtain personal benefits at the expense of the charity, e. g. use of business assets (such as office space, or even airplanes), high salaries, or valuable services, which might be viewed as too lavish by a disinterested shareholder. These suspect transactions were also viewed as being extremely difficult to police because of their frequency.

5. *Distraction of managers from charitable activities*
The concern was that the need to run an active business would consume too much time and attention of the managers of the charity, with an attendant reduction in their focus on charitable manners. I suspect that part of this notion is really something else, i. e. that the attractiveness of tax, control-perpetuating, and other benefits of private foundation ownership might tempt businessmen to create a private foundation to own their businesses when they never had any interest in charity to begin with.

6. *Erosion of tax base*
The concern was that income taxes and estate or death taxes of wealthy businessmen could be reduced or eliminated by their giving business ownership to a private foundation. That would produce a corresponding increase in the tax burden imposed on other persons and sectors of the society.

7. *Perpetuation of control*
The concern was that a private foundation could be used to maintain family control of a business for an unlimited period. This could give rise to a class of people privileged by birth, which would be at odds with the U.S. notion of a fluid society. It might also lead to management of business enterprises by people chosen by birth rather than talent, which would be at odds with the efficient functioning of the capital markets.

8. *Weakening of the company's competitive ability*
The concern was that placing control of a business enterprise in a private foundation improperly insulates the business and its managers from market forces. This reduction in exposure to normal capital market risks – such as those arising when a company needs access to new capital, or is subject to takeover bids – may make the enterprise less efficient and competitive, to the long-term disadvantage of its employees and the capital markets.

9. *Investment portfolio policy*
The concern was that having too much of the foundation's assets in the securities of a single business would adversely affect the value of and the income on its portfolio. There was some evidence that suggested that foundations tended to receive lower-than-fair-market returns on the concentrated business holdings. But even apart from evidence of lower returns, modern portfolio theory and the law of many countries teach that a fundamental duty of charitable trustees, in prudently managing their investment assets, is to diversify the portfolio to reduce or minimize uncompensated risks.

10. *Unseemliness*
The concern is that some people believe that it is inappropriate for charities to be running or owning commercial businesses. Some have referred to the Sermon on the Mount for the view that one should not serve both God and Mammon. Others have said "there is something unseemly about the use of a charitable organization to maintain control of a business"[1] or that "there is something fundamentally objectionable and incompatible with a foundation's effort to serve both the charity and the business interests of the donor."[2]

1 John R. Labovitz, 1969 Tax Reforms Reconsidered. In: The Future of Foundations 101, 114 (1973).
2 William H. Smith, Carolyn P. Chiechi, Private Foundations before and after the Tax Reform of 1969, 69 (1974).

Examples of private foundation structures

A. Examples of U.S. structures

1. The Poynter Institute was created by the will of Nelson Poynter, who died in 1978, to own the St. Petersburg Times newspaper. It also owns the Congressional Quarterly and several other medial properties. In order to avoid the excess business holding rules, the Institute persuaded the Internal Revenue Service that it qualified as an educational organization, thus avoiding private foundation status (the excess business holding rules only apply to private foundations but not public charities). The Poynter Institute carries on an extensive educational program – it has a faculty of 15 people teaching journalism and related courses. The St. Petersburg Times had revenues of about $220 million last year, and provided $4.4 million out of the total $5 million of the Institute's budget. Interestingly, if the Institute had failed to avoid the excess business holding rules, it had been forced to dispose of the newspaper which by Nelson Poynter's will would then have become property of Yale University. The affairs of the newspaper and the Institute are both managed by the same person, today Andrew Barnes, as required by the terms of the governing documents.
2. Howard Hughes Medical Institute, which used to own much of the estate of Howard Hughes, managed to qualify as a medical research institution. That made it not a private foundation thus avoiding the excess business holding rules. This not only relieved it of the obligation to dispose of concentrated holdings it received from Mr. Hughes, but also enabled it to avoid the minimum distribution rules which make private foundations in the United States distribute 5 percent of their assets each year. Its portfolio today is quite diversified and it is beginning to make substantial grants in addition to its own medical research.
3. The Kellogg Foundation receives funding from the Kellogg Foundation Trust, a wholly separate entity from the Foundation. The Trust, in turn, owns 34 percent of the Kellogg Company's common stock (down from about 47 percent in 1984, as mandated by the excess business holdings rules). The Internal Revenue Service appears to be satisfied that (in the language of the statute) effective control of the Kellogg Company lies in the hands of disinterested persons, thus allowing the trust to continue to own 34 percent (i. e., less than 35 percent) of the common stock (rather than the typical lower 20 percent) and allowing the Foundation (which does not own that stock) to continue to manage its charitable grantmaking activities without worrying about managing the Trust's portfolio. The Trust has one corporate trustee (the Bank of New York) and three individual trustees. Each of the individual trustees also serves as a director of the Foundation, and each of the individual trustees either serves or is about to serve as a director of the business, the Kellogg Company. The Kellogg Company Board of Directors has eleven members.
4. This final example from the United States, the John A. Hartford Foundation, was remarked on by Congress and has been written about substantially since then. The Hartford Foundation used to own about 20 percent of the shares of A&P, given to it in 1957 by George Hartford. The shares at one point in the 1960's were as high as $70 apiece, by in 1978 they had fallen to $5 apiece. That substantially depleted the assets of the Foundation and the shares were finally sold in 1979 to Tengelmann Warenhandelsgesellschaft.

B. Examples of structures outside the U.S.

1. The Wellcome Trust used to own control of the Wellcome Foundation company. (Note the vocabulary here: the charity is the Trust and the business is the Foundation.) The shares of the business were left to the Trust under the will of Sir Henry Wellcome. Only with the benefit of special orders from the U.K. courts was the trust able to divest itself in stages, first by selling some shares of Wellcome into the market in underwrit-

ten offerings and then (quite recently) by accepting an offer from Glaxo to dispose of its remaining 39.5 percent of the Wellcome Foundation. In the process, the income of the Trust went up dramatically. It had been less than 91 million pounds in 1991, but it was about 333 million pounds in 1995. So its medical research grants have also increased substantially. Its assets now exceed U.S. $10 billion.

2. The Nuffield Foundation used to own substantial holdings in British Leyland Motors. When the stock declined in 1975, the Foundation's assets were devastated, and its grant programs were quite significantly reduced.
3. The non-voting common stock of Barings Bank was wholly owned by (and was the principal holding of) the Barings Foundation, which was set up in 1969. After Nick Leeson worked his special magic, causing an estimated 1.4 billion pound loss to the Bank, the assets of the Baring Foundation were reduced about 85 percent, which dramatically cut the Foundation's grantmaking activities. Its grants had been about 12 million pounds in 1994. The Dutch company ING, which took over the bank's assets, agreed to underwrite the Foundation's charitable commitments for the current year, but after that Barings Foundation is on its own. The reduction in its level of giving has inflicted pain on a number of U.K. charities which had depended on funding from the Foundation.
4. The Van Leer Foundation was also set up in a tripartite fashion. The business is owned by a separate entity from the Foundation and the concentrated holdings are now in the process of being diversified with the sale of about one quarter of the holdings of the business. When that happens, the income on those assets will go up by three and a half to four times of what had been there before, allowing the foundation to increase its giving by a substantial amount.

Concluding comments

As I said, above, these policy concerns that I put forward were stated as the reasons for the legislation in the U.S. Similar if not identical concerns have been voiced in other countries. This suggests to me the desirability for a foundation – even if it is not now subject to any of such rules – to consider how to structure itself *today* so that, while meeting the goals of its founders, it will perhaps avoid *tomorrow* being "caught" or adversely affected by later-enacted legislation aimed at such perceived (even if incorrectly perceived) concerns.

I would like to suggest several governance and structural issues which private foundations with substantial business holdings might consider – I emphasize the word "consider", because my suggestions may not all be worthy and, in any event, some of them may simply be incompatible with the founders' wishes or the desired method of operation of the foundation.

1. To deal with the concern about the deferrral of charitable benefits – consider adopting some kind of spending guideline. It should not be measured by "income" (which may be constrained from time to time) but rather as a percentage of the fair fair value of the assets. It would be wise that such a guideline not be too rigid, i. e., to allow flexibility to vary the scope of charitable activities over time or in the light of unforeseen circumstances. It would be wise to provide for some method periodically to redetermine the fair market value of the foundation's assets.
2. To deal with the unfair competition concern, it might be wise to consider dealing with any concentrated business holding only on arms' length terms, and to consider generally not using charitable assets – even on arms' length terms – for the benefit of the business.
3. To deal with the conflict-of-interest concern, it might be worthwhile considering methods of locating control of the business, i. e., voting control, in an entity other than either the

business or the foundation. For example, the tripartite structure used by the Kellogg Foundation and the Van Leer Foundation might be an interesting model. The trustees or directors of such a third entity should be selected by processes designed to identify people knowledgeable about and sensitive to the needs of both the business and the foundation, and capable of balancing those needs. The tripartite concept would also address, to some extent, the concerns of distraction of managers of the foundation from their charitable activities.

4. To deal with the self-dealing concern – consider adopting a strong policy against self-dealing, and consider having it policed by periodic independent audits (perhaps by outside auditors, or perhaps by an independent audit committee).
5. To avoid the perpetuation-of-control concern two steps might be thought about:
   a. Putting in place some process for selection of future managers, of both the business and the foundation, designed to identify managers by talent. The process should both be, and – importantly – be *seen* to be, impartial and fair.
   b. Putting in place some process for possible future sale of some or all of the business holdings. Sir Henry Wellcome did not do this, a failure which cost the Wellcome Trust a lot of money, time, and trouble – because it had to go to the U.K. courts on several occasions to get the authority to dispose of its Wellcome Foundation holdings. In the fullness of time – and, because the existence of a foundation is perpetual, the relevant time frame can be quite long – there may be reasons why any given foundation will wish to, or need to, diversify or change its investments. It would be wise for founders to be involved with this question at the outset, rather than leaving it to later generations to figure out what to do without their guidance. This process would also help address the investment portfolio diversification concern.