Tax Reform: House Bill Holds Penalties for Foundations

The Tax Reform bill passed by the House of Representatives last week would not only breach the tax-exempt status of private foundations but would also force significant changes in the mode of operation of major foundations that support educational and scientific activities.

The Senate must still act, and there are reports that the Administration has reservations about the bill, but congressional observers report heavy pressure for enactment of tax reform legislation this year, and it seems at least an even bet that the House bill will emerge from the process with its main features intact.

The major changes affecting the general operations of private foundations would be these:

- A 7½ percent annual tax on the net investment income of private foundations would be levied, plus a 15 percent tax per year on undistributed income.
- Where a private foundation made an investment "which jeopardizes the carrying out of its exempt purposes" a tax equal to 100 percent of the investment would be imposed on the foundation and a tax of 50 percent on the foundation "managers."
- If a foundation were found to have "excess business holdings"—which, in general, means that it held or controlled more than 20 percent of the voting stock in an incorporated business—a tax equal to 200 percent of such holdings would be imposed after a grace period.
- The rules on political activity of foundations would be drastically tightened to prohibit support of any activities that would influence legislation or public elections.

Foundation officials find this last section particularly alarming because it charges foundations not only with the auditing of expenditures to government satisfaction but also makes the foundations legally responsible for seeing that foundation grants are used for the purposes made. These features and ambiguities in this and other sections of the law cause foundation officials to regard the bill as what one termed an "administrative monstrosity."

On the face of it, the restrictions on foundations were somewhat less severe than those contained in a memorandum of "tentative decisions" released by the House Ways and Means Committee on 27 May. At that point, the committee had decided on a wholesale prohibition of the making of grants to individuals by foundations. Had the committee not relented, funds would have had to go through institutions such as universities.

It was inferred at the time that the restrictions would bear heavily on tax-exempt organizations such as national scientific and scholarly associations and nonprofit research organizations. Officials at the Brookings Institution in Washington, for example, said it appeared that Brookings would not be able to operate under the proposed law. The version of the bill passed by the House made a distinction between private foundations and "operating" foundations, and the latter appeared to be excluded from many of the stiff restrictions on private foundations. Exempt were churches, schools or colleges, organizations testing for public safety, and organizations receiving a substantial part of their support from a governmental unit or from contributions by the general public. Some lawyers who deal with tax matters, however, say that the definition of private foundations is not clear enough for them to be certain where the line can be drawn.

Self-Dealing Prohibitions

Some of the provisions in the House bill are warmly welcomed by most foundation officials. These are the limitations on "self-dealing." A relatively small number of persons involved with foundations interpreted too literally the adage that charity begins at home. They took advantage of foundation law mainly to gain tax advantages and attracted unfavorable publicity for the foundations—particularly from the dogged investigation over the years of Texas Congressman Wright Patman. The new bill hits at self-dealing with a series of provisions prohibiting certain types of loans, stock transactions, property dealings, and compensation payments.

More controversial is the section on tax treatment of charitable contributions. College and university authorities are apprehensive that gifts to their institutions would be reduced by the provisions. The eventual ending of unlimited deductions on charitable gifts is a main point in question.

The announced intention of Ways and Means Committee chairman Wilbur Mills and his colleagues has been to introduce a greater measure of equity into the tax structure. In the case of the foundations, however, the committee would appear to have acted on some points in a punitive if not vindictive spirit.

If an organization should decide to terminate its status as a private foundation, for instance, it would have to pay an amount equal to the aggregate tax benefit enjoyed over the years although the bill indulgently specifies that amount would not exceed the value of the foundation's net assets.

The 7½ percent on investment income—raised, incidentally, from 5 percent since the May memo—is higher than the tax a foundation would be required in most cases to pay if it were a private corporation eligible for regular deductions.

The clearest expression of the congressional mood is probably to be found in restrictions on grants to individuals in the section on "Taxes on Taxable Expenditures." A taxable expenditure is defined as any amount spent by a foundation

"(1) to carry out propaganda or otherwise attempt to influence legislation,

"(2) to influence the outcome of any public election (including voter registration drives carried on by or for such foundations),

"(3) as a grant to an individual for travel, study or other similar purposes by such individual" unless the grant is awarded "on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary (of the Treasury) or his delegate, if it is demonstrated to the satisfaction of the Secretary or his delegate that it constitutes a scholarship or fellowship at an educational institution . . . or that the purpose of the

grant is to achieve a specific objective, produce a report or other similar products, or improve or enhance a literary, artistic, musical, scientific, or other similar capacity, skill or talent."

Foundations are expressly prohibited from "any attempt to influence legislation through an attempt to affect the opinion of the general public or any segment thereof," and also "any attempt to influence legislation through private communication with any member or employee of a legislative body who may participate in the formulation of the legislation, other than through making available the results of nonpartisan analysis or research."

Voter Registration

The law as written discourages contributions by foundations to voter registration drives in particular areas. To be exempt, grants to aid voter registration, for example, can go only to organizations which engage in nonpartisan political activity in five or more states.

The penalty for making "taxable expenditures" would be a tax equal to 100 percent of such expenditures on the foundation and of 50 percent on the foundation manager who knowingly "agrees to the taxable expenditure . . ."

In making grants to individuals and organizations the foundations would be responsible

"(1) to see that the grant is spent solely for the purpose for which made,

"(2) to obtain full and complete reports from the grantee on how the funds are spent, and to verify the accuracy of such reports, and

"(3) to make full and detailed reports with respect to such expenditures to the Secretary or his delegate."

In the gloomy frame of mind into which foundation officers have been cast they see themselves propelled into new and uncomfortable relations with both their grantees and governmental officials. Foundations would be legally responsible for policing the activities of their grantees and presumably would not only have to make detailed reports to governmental officials but would have to seek government approval for programs which differ from established ones. The result, foundation sources predict, would be that modest, timely studies and innovative projects would be discouraged. If the law is enacted in its present form, it appears inevitable that foundations will be further bureaucratized and that foundation officials, faced with the toils of red tape and severe penalties, organizational and personal, for infractions, will be much less adventurous in backing the risk-taking projects which have given some foundations their finest hours, if, sometimes, their most controversial.

Curbing the foundations, however, seems to be precisely what the Ways and Means Committee intended and the House acquiesced in. And the foundations seem not to know what hit them or why.

Unquestionably the sins of self-dealing, dinned into the Congressional consciousness over the years by Wright Patman, conditioned attitudes toward foundations in a Congress not disposed to make the distinction between most foundations and an erring minority.

Congressional reaction is doubtless also related to the evolution in foundation activities. When foundations endowed libraries, financed basic research or bankrolled grantees' studies of architecture in Paris or music in Rome, foundations were benevolently ignored. But when philanthropy expanded into support of social action projects such as boat-rocking school projects in Brooklyn or voter-registration drives in the Deep South, Congressional nerves were touched.

This year, the travel and study grants made by the Ford Foundation to eight former members of Robert Kennedy's staff and the Wolfson Foundation research grant accepted and then returned by former Supreme Court Justice Abe Fortas became grievances on Capitol Hill.

As the political weather for foundations worsened, it became important really for the first time that the foundations had no strong constituency in Congress. The foundations had their defenders. Representative Emilio Daddario (D–Conn.), chairman of the House Space Committee's subcommittee on science, research, and development, wrote to Mills warning of the serious potential loss to the government of scientific and technical information and advice under terms of the draft legislation. Representative Peter Frelinghuysen (R–N.J.) in floor debate made a strong defense of the value and effectiveness of foundations under their present status. But no organized support developed.

It is easier to understand the lowering of the boom on the private foundations in the context of circumstances surrounding the tax bill. Momentum for an overhaul of the tax laws developed rather suddenly in February. Efforts to legislate tax reform in the Kennedy era had proved abortive, and a tax bill at the beginning of the year looked to be a prohibitive long shot. The motive force for the legislation, however, is widely acknowledged to be the so-called taxpayers' rebellion, which has activated the middle class, a group resentful of growing tax burdens and piqued by what they view as the success of the rich in avoiding a fair share of taxes.

The Ways and Means Committee has operated under heavy pressure of time and of contending interests and under unusually effective security wraps, and some critics argue that the resulting bill shows that not enough time has been taken for a job of such size and complexity.

Foundations First

Foundations were first on the agenda when hearings began and foundation officials were given a generally severe grilling. The discussion for the most part centered on self-dealing issues. When the committee's legislative intentions were unveiled in May, the effect on the foundations was electric since there had been no real discussion of most of the broader restrictions and penalties. Real discussion was virtually foreclosed in the floor debate since the bill came to the floor under a closed rule, allowing only 6 hours of debate for the entire measure and effectively preventing floor amendments.

The Senate now becomes the arena for tax reform action. The Finance Committee has announced it will schedule 4 weeks of hearings, beginning when Congress returns after Labor Day from its recess, and then a further 4 weeks of closed sessions.

The prognosis is uncertain. The foundations should get a chance to be heard on the provisions that would so deeply affect their operations. Efforts will certainly be made to open the bill for change or amendment. But whether foundations will succeed in winning an easing of restrictions or a removal of ambiguities in the Senate, or in the House-Senate conference which would follow, remains to be seen, particularly since the foundations will be competing for attention and sympathy with such practiced and powerful performers as the oil and gas lobby. All that seasoned observers will predict is an epic struggle.—JOHN WALSH