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The Tax Law of Private Foundations

2021 Cumulative Supplement

Fifth Edition

Bruce R. Hopkins, Jody Blazek

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Contents

Preface

This is the third supplement to accompany *The Tax Law of Private Foundations, Fifth Edition*. The supplement covers events occurring from the middle of 2018 (where the main volume ended) through the middle of 2021.

Much of the law developments that have occurred during the period reflected in this supplement concern the self-dealing rules, with emphasis on the law concerning indirect self-dealing. The book's treatment of this area of private foundation law has been rewritten and expanded. Particular attention is accorded the estate administration exception, in part because of two recent significant IRS private letter rulings on the point, plus a ruling on the matter of a foundation's expectancy.

Private foundation law is not frequently the subject of court opinions. One court case emerged during the covered period: the *Dieringer* case. Framed as an estate tax charitable deduction valuation case, the set of facts really is a case study in indirect self-dealing. The case is treated from that perspective in this supplement.

Other interesting private letter rulings during the period include aspects of the mandatory payout rule, the law concerning functionally related businesses and program-related investments, spending for charitable purposes, and the qualified appreciated stock rule.

There was some hope that the proposed Department of the Treasury regulations concerning donor-advised funds would materialize during the period—they are likely to constitute the stuff of a supplement by themselves—but, to date, nothing in that regard has occurred.

A supplement of this nature would not be complete without an update on applicable law generated by the Tax Cuts and Jobs Act. Included in this supplement are summaries of the Treasury Department's and the IRS's regulation on the bucketing and excess compensation tax laws. Discussion of the latter has been expanded to include summaries of exceptions particularly applicable to private foundations.

Sections have been added summarizing the IRS's rules concerning private foundations' funding of disaster relief programs and the import of the prospective revision of the group exemption rules. In celebration (if that is the right word) of the 50-years' existence of the private foundation tax laws, a brief perspective on that phenomenon is included.

Thanks go to Brian T. Neill, Deborah Schindlar, and Sharmila Srinivasan at John Wiley & Sons, Inc., for their hard work and invaluable help in connection with preparation of this supplement.

Bruce R. Hopkins

Book Citations

Throughout this book, 11 books by the authors (in some instances, as co-author), all published by John Wiley & Sons, are referenced in this way:

1. Hopkins, *IRS Audits of Tax-Exempt Organizations: Policies, Practices, and Procedures* (2008): *IRS Audits*.
2. Hopkins, *The Law of Fundraising, Fifth Edition* (2013): *Fundraising*.
3. Hopkins, *The Law of Intermediate Sanctions: A Guide for Nonprofits* (2003): *Intermediate Sanctions*.
4. Hopkins, *The Law of Tax-Exempt Organizations, Twelfth Edition* (2019): *Tax-Exempt Organizations*.
5. Hopkins, *Nonprofit Governance: Law, Practices & Trends* (2009): *Nonprofit Governance*.
6. Hopkins, *Nonprofit Law for Colleges and Universities: Essential Questions and Answers for Officers, Directors, and Advisors* (2011): *Colleges and Universities*.
7. Hopkins, *Planning Guide for the Law of Tax-Exempt Organizations: Strategies and Commentaries* (2004): *Planning Guide*.
8. Hopkins, *The Tax Law of Charitable Giving, Sixth Edition* (2021): *Charitable Giving*.
9. Hopkins, *The Tax Law of Unrelated Business for Nonprofit Organizations* (2005): *Unrelated Business*.
10. Hopkins, *The Law of Tax-Exempt Healthcare Organizations, Fourth Edition* (2013): *Healthcare Organizations*.
11. Hopkins, *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (2012): *Constitutional Law*.

The second, fourth, eighth, and tenth of these books are annually supplemented. Also, updates on all of the foregoing law subjects (plus private foundations law) are available in *Bruce R. Hopkins' Nonprofit Counsel*, a monthly newsletter also published by Wiley.

The **Tax Law** of **Private Foundations**

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CHAPTER ONE

Introduction to Private Foundations

§ 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

p. 1, first line. ***Delete*** **millions of** ***and insert:***

over 1.5 million[1]

p. 1. ***Delete second paragraph.***

p. 1, note 1, third line. ***Insert period following*** **26;** ***delete remainder of note.***

p. 2, note 1. ***Change footnote number to*** **1.1.**

[1]The IRS Data Book, 2018 (Pub. 55B) informs that there are, as of the federal government's fiscal year 2018, 1,327,714 recognized charitable and like organizations in the United States, plus 115,778 nonexempt charitable trusts and split-interest trusts and 216 apostolic entities. This number of charitable organizations does not include religious organizations that are not required to seek recognition of tax exemption or entities covered by a group exemption.

§ 1.2 DEFINITION OF PRIVATE FOUNDATION

p. 5, note 10. ***Insert before period:***

; IRS Revenue Procedure (Rev. Proc.) 2021-5, 2021-1 I.R.B. 250, § 7.03

§ 1.4 PRIVATE FOUNDATION LAW PRIMER

p. 8, last line. ***Insert footnote*** **22.1** ***following period:***

[22.1]IRC Chapter 42 (IRC §§ 4940–4948).

§ 1.5 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT

p. 16, note 75. ***Delete second*** **75.*****; convert semi-colon to period and delete remainder of note.***

p. 16, note 76. ***Convert semi-colon to period and delete remainder of note.***

p. 16, note 77. ***Convert semi-colon to period and delete remainder of note.***

p. 16, note 78. ***Convert semi-colon to period and delete remainder of note.***

p. 16, note 79. ***Convert semi-colon to period and delete remainder of note.***

p. 16, note 82. ***Convert semi-colon to period and delete remainder of note.***

§ 1.6 DEFINITION OF CHARITY

p. 17, note 85. ***Convert semi-colon to period and delete remainder of note.***

p. 17, note 86. ***Convert semi-colon to period and delete remainder of note.***

p. 17, note 87. ***Convert second comma to period and delete remainder of note.***

§ 1.7 OPERATING FOR CHARITABLE PURPOSES

p. 18, carryover paragraph, first line. ***Insert footnote*** **88.1** ***following period:***

[88.1]Reg. § 1.501(c)(3)-1(c)(1).

p. 18, carryover paragraph, sixth line. ***Delete*** **organizational** ***and insert*** **operational.**

p. 18, carryover paragraph. ***Delete fifth complete sentence, including footnote.***

p. 18, note 89. ***Delete text and insert:***

A private foundation had its tax-exempt status revoked for failing to engage in any exempt activities over a long period of time (Community Education Foundation v. Commissioner, 112 T.C.M. 637 (2016), appeal dismissed due to lack of representation by legal counsel).

p. 18, note 90. ***Delete text and insert:***

In general, *Tax-Exempt Organizations* § 4.4.

p. 19, note 102. ***Delete text beginning with*** **and** ***and through*** **Compliance.**

§ 1.9 PRIVATE FOUNDATION SANCTIONS

p. 24. ***Change heading to read:***

PRIVATE FOUNDATION LAW SANCTIONS

pp. 24–26. ***Delete text following heading on page 24 and through the first complete paragraph on page 26, and insert:***

The federal tax rules pertaining to private foundations[136] are often characterized in summaries as if they are typical laws, in the sense of prescriptions governing human behavior. This is not the case; these rules, comprising portions of the Internal Revenue Code, are tax provisions. Thus, this body of law states that, if a certain course of conduct is engaged in (or, perhaps, not engaged in), imposition of one or more excise taxes will be the (or a) result. For example, there is no rule of federal tax law that states that a private foundation may not engage in an act of self-dealing;[137] rather, the law is that an act of self-dealing will trigger one or more excise taxes and other sanctions.[138]

(a) Sanctions (a Reprise)

Because of the nature of this statutory tax law structure, a person subject to an excise tax does not merely pay it and continue with the transaction and its consequences, as is the case with nearly all federal tax regimes. This structure weaves a series of spiraling taxes from which the private foundation, and/or disqualified person(s) with respect to it, can emerge only by paying one or more taxes and correcting (undoing) the transaction involved by paying or distributing assets or having the foundation's income and assets confiscated by the IRS.

The private foundation rules collectively stand as sanctions created by Congress for the purpose of curbing what was perceived as a range of abuses being perpetrated through the use of private foundations by those who control or manipulate them. These provisions comprise Chapter 42 of the

[136]E.g., § 1.4(a)-(h).

[137]State law, however, may contain such a rule. E.g., Neb. Rev. Stat. § 21-1916.

[138]Even the IRS occasionally gets this wrong. For example, in a private letter ruling, the IRS stated that certain payments by a private foundation to disqualified persons "would be acts of self-dealing that are prohibited by Chapter 42 of the Internal Revenue Code" (Priv. Ltr. Rul. 201703003).

Internal Revenue Code. Some of these constraints were placed on supporting organizations and donor-advised funds in 2006.[139]

(b) Self-Dealing Sanctions as Pigouvian Taxes

In the self-dealing context, two excise taxes are imposed on self-dealers—the initial tax[140] and the additional tax.[141] The first tax has a rate of 10 percent; the second a rate of 200 percent. There are also taxes on foundation managers where there is knowing participation in the self-dealing transaction (a scienter requirement).[142] The foundation self-dealing tax subjects the entire amount involved in a self-dealing transaction to tax. Also, the initial self-dealing tax cannot be abated by the IRS.[143] There is the correction feature, by which the self-dealer is required to pay the amount involved to the foundation.[144]

What has come to be known as the *Pigouvian tax* is the brainchild of English economist Arthur Cecil Pigou (1879–1959), a contributor to modern welfare economics. He introduced the concept of *externality* and the belief that externality (social problems) can be corrected by imposition of a tax. A commentator wrote that Pigouvian taxes "aim to regulate behavior by placing a small tax, usually in the form of a uniform excise tax, on the activity to be regulated because of the harm it produces for members of the public."[145]

Does the federal self-dealing tax regime constitute one or more Pigouvian taxes? On the face of it, the answer would seem to be yes.[146] This commentator nicely observed that the self-dealing taxes "have the Pigouvian impulse to protect the public from harm by imposing an excise tax."[147] Despite this impulse, however, three reasons were posited why the self-dealing taxes are not Pigouvian in nature. One, the additional excise tax rate of 200 percent is not "small." Two, the initial tax subjects the entire amount involved in a self-dealing transaction to tax, "even if the transaction benefits the foundation," so that, in those circumstances, the requisite "social costs" are not involved.[148] Third, a Pigouvian tax assumes uniform social costs across all individuals and firms; the commentator mused whether "differences between large and small foundations,

[139]See Chapters 15 and 16.
[140]IRC § 4941(a)(1).
[141]IRC § 4941(b)(1).
[142]IRC § 4941(a)(2), (b)(2).
[143]IRC § 4962(b).
[144]IRC § 4941(e)(3).
[145]Aprill, "The Private Foundation Excise Tax on Self-Dealing: Contours, Comparisons, and Character," 17 *Pitt. L. Rev*. 297 (Spring 2020).
[146]This is because of the inherent purpose of these taxes, which is to regulate behavior, with the sanctions more in the nature of penalties than taxes (see § 1.9(c)).
[147]Aprill, *supra* note 145, at 329.
[148]*Id*. at 328.

between corporate and family foundations, local and national foundations, old and new foundations, etc. should shape the applicable excise tax rules."[149]

Yet, it is understandable why one, perhaps not an economist, would conclude that the self-dealing taxes are Pigouvian in nature, if only because the initial tax cannot be abated and because of the correction requirement. The U.S. Supreme Court stated the general rule about a tax: "Imposition of a tax nonetheless leaves an individual with a lawful choice to do or not do a certain act, so long as he is willing to pay a tax levied on that choice."[150] The self-dealing tax regime does not allow for that type of "lawful choice."

(c) Self-Dealing Sanctions: Taxes or Penalties?

Federal constitutional law differentiates between a tax and a penalty—at least conceptually. This distinction may be drawn in determining whether the exaction passes constitutional muster. A dramatic illustration of this point occurred when a bare majority of the U.S. Supreme Court upheld the constitutionality of the Patient Protection and Affordable Care Act on the basis of Congress's taxing power, construing the health insurance individual mandate (or shared-responsibility payment) as a tax, after the decision was made that the mandate could not be justified as constitutional pursuant to the Commerce Clause.[150.1] On that occasion, however, the Court observed that "Congress's ability to use its taxing power to influence conduct is not without limits."[150.2]

In this opinion, the fact that there is a difference between a tax and a penalty was raised, but not resolved. The Court wrote that "there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty with the characteristics of regulation and punishment."[150.3] Also, the Court stated that, "[i]n distinguishing penalties from taxes, this Court has explained that 'if the concept of penalty means anything, it means punishment for an unlawful act or omission.'"[150.4] The Court concluded, having decided that the individual mandate (or shared-responsibility payment) is a tax for constitutional law

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[149] *Id*.

[150] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 574 (2012).

[150.1] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519 (2012). The Tax Clause is the subject of U.S. Constitution Article I § 8. For a detailed summary of this opinion, see Hopkins, *Tax-Exempt Organizations and Constitutional Law: Nonprofit Law as Shaped by the U.S. Supreme Court* (Hoboken, NJ: John Wiley & Sons, 2012) § 4.8.

[150.2] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 572 (2012).

[150.3] *Id*. at 573.

[150.4] *Id*. at 567, quoting United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213, 224 (1996).

purposes, wrote that "we need not here decide the precise point at which an exaction becomes so punitive that the taxing power does not authorize it."[150.5] It should be remembered that, even if an exaction is determined to be a penalty, the constitutionality of the statutory structure may be upheld under the Commerce Clause.[150.6]

In the opinion, the Court principally relied on two of its precedents in discussing what is and is not a tax. In one of these cases, the Court wrote that a "federal excise tax does not cease to be valid merely because it discourages or deters the activities taxed."[150.7] It was stated that a tax may have a "regulatory effect" but remains a tax if it "produces revenue."[150.8] The Court added: "It is axiomatic that the power of Congress to tax is extensive and sometimes falls with crushing effect on businesses deemed unessential or inimical to the public welfare."[150.9] In the other of these cases, the Court concluded that an ostensible tax was a penalty, because the sanction imposed a heavy burden, included a scienter requirement, and was enforced by a federal agency other than the Department of the Treasury.[150.10]

The Supreme Court observed, in 1974, that the Court in its "early cases" drew what it saw at the time as distinctions between regulatory and revenue-raising taxes, adding "[b]ut the Court has subsequently abandoned such distinctions."[150.11] These "early cases" included six court decisions concerning the private foundation law sanctions.

Several court opinions focus on the constitutionality of the federal self-dealing law. In one of these cases, the principal contention was that the provision is an unconstitutional extension of the congressional taxing

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[150.5] National Federation of Independent Businesses v. Sebelius, 567 U.S. 519, 573 (2012). Earlier in its opinion, the Court majority held that the payment was not a tax for statutory law purposes.

[150.6] The shared-responsibility payment was reduced to zero, effective January 1, 2019, by enactment of the Tax Cuts and Jobs Act (Pub. L. No. 115-97, 131 Stat. 2054 (2017)). A federal court held that the entirety of the Affordable Care Act, as modified by the TCJA, is unconstitutional because the individual mandate is now unconstitutional because it can no longer be justified as a tax and the mandate is inseverable from the Act's remaining provisions (Texas et al. v. United States, 336 F. Supp. 3d 664 (N.D. Tex. 2018)). An appellate court agreed with the district court as to the present-day unconstitutionality of the individual mandate but remanded the case for a more detailed analysis as to severability (Texas et al. v. United States). The U.S. Supreme Court, on January 21, 2020, declined to expedite its review of this case (U.S. House of Representatives v. Texas, No. 19-841; California et al. v. Texas, No. 19-840). The Fifth Circuit, on January 29, 2020, denied a request for a full-panel hearing of the case (Texas et al. v. United States, No. 19-10011). The U.S. Supreme Court ended this litigation by holding that the plaintiffs lacked standing (California v. Texas, No. 19-840).

[150.7] United States v. Kahriger, 345 U.S. 22, 28 (1953).

[150.8] *Id*.

[150.9] *Id*.

[150.10] Bailey v. Drexel Furniture, 259 U.S. 20 (1922).

[150.11] Bob Jones University v. Simon, 416 U.S. 725, 791, note 12 (1974).