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THE FIVE PERCENT FIG LEAF

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INTRODUCTION

What do we ask of private foundations? What should we?

The current answer to this first question, provided by Tax Reform Act of 1969, and continuing to this day, is the annual payout requirement which requires private foundations to spend 5% of their assets each year. Under this rule, a private foundation with assets in a given year of \$10,000,000, would be required to spend \$500,000 on charitable purposes in the following year, or else face a penalty.¹ The purpose of the payout requirement rule was to address the concern that donors to private foundations get significant up-front tax benefits for their creation of a private foundation, but that, absent a payout rule, there could be a near unlimited delay between the time of tax benefits and the time the public benefited from the charitable activities of the private foundation.

Judging by appearances, the 5% rule is stronger than ever. For at least fifteen years there have been no Congressional proposals or lobbying efforts to change the 5% payout rule.² Moreover, the 5% payout rule has become widely accepted and widely touted (by the foundation world, among others) as a reasonable compromise that allows private foundations to exist in perpetuity while ensuring that a portion of their funds be put to current charitable use. Even more importantly, the 5% payout rule has served to legitimate private foundations to the public, by giving foundations a readily recognized role of providing steady sources of capital to nonprofits. All of

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¹ Although this is commonly referred to as a payout requirement, a more accurate description is that a tax is imposed on those private foundations that fail to meet the 5% payout rule. I.R.C. § 4942.

² *See id.*

these things make it seem that the 5% payout rule is well established as both a practical and theoretical matter.

However, despite the apparently robust nature of the 5% payout rule, this Article argues that the 5% payout rule operates more as a fig leaf than as a meaningful control on private foundation spending. Analyzing how the rule operates fifty years after its enactment, it has become increasingly evident that the meaning of the term “payout” is so elastic that the rule cannot be relied upon to fulfill its stated purpose of ensuring the current flow of dollars to charitable activities. In particular, the ability to meet payout requirements by: (1) paying unlimited administrative expenses of the foundation (including salaries and travel expenses for family members), (2) making unlimited contributions to donor-advised funds (which themselves have no further payout requirement), and (3) making investments (provided they qualify as “program-related investments”) give private foundations ample opportunity to skirt the purpose, while still fulfilling the letter, of the law governing payout.

This Article proceeds in three parts. Part I outlines the law and history of private foundation regulation. It begins with a brief description of the tax benefits of creating private foundations, and then turns to the particular rules and restrictions applicable to private foundations, including the 5% payout requirement. Part II then turns to consider whether under the current rules the payout rule actually works to accomplish its intended goals. Finally, Part III considers policy proposals designed to refine the rules so that they can more closely fulfill the larger purpose of the rules providing tax benefits for charitable giving.

I. TAX BENEFITS OF CREATING PRIVATE FOUNDATIONS

Current law provides numerous tax benefits for donors making charitable gifts, including funding private foundations.³ Charitable donations

³ I.R.C. § 170. All charitable organizations are categorized as either public charities or private foundations. In general, public charities receive funds from a broad group of donors and have boards that are responsive to such donors, while private foundations are often funded and controlled by one person or family. For example, the United Way and the American Cancer Society are public charities because they receive substantial support from the general public. The Ford Foundation is a private foundation because it received its funding from a single family. Federal tax law draws a distinction between the two because Congress saw more opportunity for abuse and a greater need for regulatory oversight for private foundations. Congress also decided that the charitable deductions for donations to private foundations

are eligible for the income tax charitable contribution deduction (which can provide benefits up to 37% of the gift for taxpayers in the highest tax bracket).⁴ In addition, if the donor transfers appreciated property instead of cash, then the donor can also avoid a tax on the capital gains that would otherwise be imposed on the sale of the property.⁵ These can save a donor up to an additional 20% of the value of the gift. Finally, property transferred to charity is not subject to estate or gift taxes.⁶ The combined effect of these provisions is that donors can save up to 74% in taxes for their charitable gifts.⁷

Up until the middle of the 20th century, all charitable donations were treated the same for tax purposes, regardless of whether the charitable organization receiving the property received broad public support and was engaged in direct charitable work (such as operating a soup kitchen or running a museum, hospital or college), or whether it was funded by an individual or family and simply held donated funds for the eventual distribution to other individuals or organizations doing direct charitable work.⁸ There was a single rule that simply required that all charitable

should be more limited than donation to public charities. RAY D. MADOFF ET AL., *Charitable Giving*, in PRACTICAL GUIDE TO ESTATE PLANNING § 10.03[A] (2020).

⁴ See I.R.S. Pub. No. 526, Charitable Contributions (2019); 7 *Charitable Tax Deduction Questions Answered*, FIDELITY CHARITABLE, <https://www.fidelitycharitable.org/guidance/charitable-tax-strategies/charitable-tax-deductions.html> (last visited Apr. 14, 2020).

⁵ I.R.S. Pub. No. 5526, Charitable Contributions 12 (2019).

⁶ I.R.C. §§ 2055 & 2522.

⁷ Why does Congress provide such generous tax benefits for charitable giving? The prevailing view is that subsidies make up for two market failures, one economic and one political. Despite our best intentions, most humans remain at least somewhat self-interested. We therefore are usually unwilling to pay fully for benefits that accrue to other people—what an economist would call “positive externalities.” Many goods, once purchased by one person, provide additional spillover benefits to others, so that no one individual has an incentive to provide as much as would be ideal from a social perspective. Examples include public parks, museums, and medical research. By offering tax benefits, Congress hopes that we can be motivated through selfish considerations to purchase more of the positive-externality goods, moving society closer to the level it would choose if not for the market’s failure. Brian Galle & Ray Madoff, *The Myth of Payout Rules: Where Do We Go from Here?*, in *GIVING IN TIME* (Benjamin Soskis ed., Urban Institute Press forthcoming).

⁸ See Vada Waters Lindsey, *The Charitable Contribution Deduction: A Historical View and a Look to the Future*, 81 NEB. L. REV. 1056, 1061–68 (2003).

organizations be “organized and operated for ‘charitable’ purposes”⁹ However, the exponential growth of private charitable foundations along with their use for political purposes and explicit and audacious marketing of private charitable foundations as tax shelters for the wealthy brought Congressional attention.¹⁰

Congress was particularly concerned about the disconnect between the time of tax benefit for donors and the time of benefit for society. In the words of the Joint Committee on Taxation Bluebook, “As a result, while the donor may have received substantial tax benefits from his contribution currently, charity may have received absolutely no current benefit.”¹¹ This concern was especially great at the time when, due to high tax rates, the tax benefits of charitable giving were even more beneficial than they are today.¹²

Congress was sensitized to the importance of this issue by the development and acceptance of the concept of “tax expenditure” in the 1960s.¹³ At that time, Assistant Secretary of the Treasury Stanley Surrey developed the theory that tax preferences were functionally equivalent to direct government spending.¹⁴ The theory of tax expenditures has become well accepted and is used by the Congressional Budget Office in calculating the federal budget.¹⁵ Applying the tax expenditure analysis, if a taxpayer were to receive a \$4,000,000 reduction in taxes for creating a \$10,000,000 private foundation that was recognized as being functionally the same as if the donor contributed \$6,000,000 and the government contributed

⁹ IRS EO CPE TEXT, THE CONCEPT OF CHARITY 1-4 (1980), <https://www.google.com/search?q=the+concept+of+charity+irs&aq=chrome.0.69i59j0.3689j0j7&sourceid=chrome&ie=UTF-8>.

¹⁰ See Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspective on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52 (2000).

¹¹ STAFF OF THE J. COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 36 (Comm. Print 1970) [hereinafter J. COMM. ON TAXATION].

¹² The highest marginal rate was 77% in 1969, compared to 37% in 2020.

¹³ See generally Lindsey, *supra* note 8.

¹⁴ Stanley Surrey, *Federal Income Tax Reform*, 84 HARV. L. REV. 352 (1970).

¹⁵ CONG. BUDGET OFFICE, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM I (2013).

\$4,000,000 toward the creation of that private foundation.¹⁶ Seen as a substitute for direct spending, it is not surprising that Congress began to ask what the public was receiving in exchange for this significant current “expenditure” of public resources.

The first proposals considered ensuring that charitable funds would be put to use in a timely manner by limiting the life of private foundations to a term of twenty-five or forty years. Although term limits were ultimately rejected, Congress did enact provisions designed to assure distribution of at least a portion of the private foundation’s assets. The first rules, enacted in 1954, did not require specific payout of funds, but instead provided that a private foundation could lose its tax-exempt status if its accumulation of income was “unreasonable in amount and duration.”¹⁷ This rule had little practical effect as the standard was too vague and the penalty—loss of exempt status—was so draconian that it was rarely imposed.

As a result of dissatisfaction with the rule against accumulation of income, Congress was urged by the Treasury to enact a rule regarding payout that would be more effective.¹⁸ The proposed remedy was to impose a mandatory payout of all of a foundation’s net income on a reasonably current basis.¹⁹ Congress adopted a form of Treasury’s proposal when it enacted the Tax Reform Act of 1969. As originally enacted, the payout rule required private foundations to distribute the greater of the private foundation’s net investment income or 6%. However, this was eventually modified to the current rule that imposed a tax on private foundations that fail to spend at least 5% of their assets each year on their charitable purpose. Under this rule,

¹⁶ William McBride, *A Brief History of Tax Expenditures*, TAX FOUND. (Aug. 22, 2013), <http://taxfoundation.org/article/brief-history-tax-expenditures>. Beginning in 1974, Congress required that these tax expenditures be recorded annually as part of the federal budget. See Stanley Surrey, *Federal Income Tax Reform*, 84 HARV. L. REV. 352 (1970).

¹⁷ I.R.C. § 504(a)(1) (1954) (repealed by Pub. L. No. 91-172, § 101(j)(15)).

¹⁸ COMM. ON FINANCE, 89TH CONG., TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS (Comm. Print 1965).

¹⁹ This remedy proposed that private non-operating foundations must expend all net income by the end of the year following the year such income is received, including ordinary investment income and short-term capital gains. See J. COMM. ON TAXATION, *supra* note 11.

our \$10,000,000 private foundation would be required to “pay out” at least \$500,000 per year or else be subject to a penalty tax.

II. HOW MEANINGFUL IS THE FIVE PERCENT PAYOUT RULE?

The purpose of the 5% payout rule was to require private foundations to make regular distributions of their assets for charitable purposes. Private foundations typically meet their 5% payout obligations by making grants to public charities. However, the rules provided in the tax code are not so limited. “Qualifying distributions” are defined in section 4942(g) as meaning any amount paid to accomplish the organization’s charitable purpose (including reasonable administrative expenses) or any amount paid to acquire an asset used to carry out its exempt purpose.²⁰

As a result of this broad definition, in addition to outright grants to public charities, minimum distribution requirements can also be met by: (1) paying administrative expenses of the foundation, including salaries, which can go to family members, (2) making contributions to donor-advised funds (from which there are no further payout requirements), and (3) making program-related investments.²¹ Taken together, these rules provide ample opportunity for foundations to satisfy their 5% payout obligation without making any traditional grants to support charitable activities.

A. Administrative Expenses

A private foundation can meet its 5% payout requirement by paying salaries, trustee fees and other administrative expenses. The only limitation on administrative expenses is that they be “reasonable and necessary.”²² Once they satisfy that standard, there is no overall limitation on the total amount of administrative expenses that can qualify.

The result of this rule is that a significant portion of a private foundation’s payout obligation can be met by salaries, rent, trustee fees and

²⁰ Excluded from this are contributions to organizations controlled by the foundation or a disqualified person with respect to the foundation and contributions to private foundations. I.R.C. § 4942(g)(1)(A).

²¹ *Id.*

²² *Id.*

travel expenses. The ability to credit these expenses might make sense for the largest private foundations with professional staffs, since the charitable work that these organizations are doing is primarily the administrative work of choosing and supporting grants. However, this rule allowing unlimited administrative expenses is more troubling in the context of small family foundations where a significant portion of the administrative fees is likely to flow to the donor's family and friends.²³ Thus, to return to our example of our \$10,000,000 foundation, it is possible for most or all of the \$500,000 payout requirement to be met by paying salaries to the donor's children, maintaining a nice office space and paying travel expenses for annual meetings in exotic locales.

In part to address these concerns, in 2003 bi-partisan legislation proposed adjustments to the administrative expenses provision.²⁴ The proposed legislation would have prohibited operating expenses, like rent and salaries, from qualifying as distributions for purposes of the 5% payout rule.²⁵ However, the legislation did not pass—meaning private foundations can continue to include administrative expenses within qualifying distributions to meet the 5% payout rule.

B. Donor-Advised Funds

Private foundations most typically meet their payout obligations by making outright distributions to public charities. Typically, these donations take the form of outright distributions to universities, hospitals, churches, food banks, museums and other organizations, engaged in direct charitable activities. Applied this way, it is easy to understand how Congress believed the payout rule would assure that private foundation assets would be put to current charitable use.

²³ Sloan C. Wiesen, *Foundation Alms for the Rich?*, NAT'L COMM. FOR RESPONSIVE PHILANTHROPY (2003), http://www.ncrp.org/wp-content/uploads/2020/06/RP-Fall2003-Foundation_Alms_for_the_Rich.pdf.

²⁴ See, e.g., CARE Act, S. 272, 108th Cong. (2003); Charitable Giving Act, H.R. 7, 108th Cong. (2003).

²⁵ Ian Wilhelm & Brad Wolverton, *Pushing Grant Makers*, CHRONICLE OF PHILANTHROPY 15 (May 15, 2003).

However, the term public charity is not limited to those organizations engaged in direct charitable work. It also includes grant-making institutions—like community foundations—provided the organization receives broad public support.²⁶ Thus, private foundations can also meet their payout obligations by making distributions to community foundations and other publicly supported grant-making organizations.

This exception originally did not raise many concerns because the ultimate spending decisions over community foundation funds were made by the managers of the community foundations and there was every reason to believe that spending decisions would be based on the interests and needs of the community being served.

However, community foundations promoted a vehicle that would prove to be very effective in attracting charitable dollars (even if less effective in getting funds to the local community): the donor-advised fund.²⁷ In order to accomplish the tax goals of giving the donor a current charitable donation, contributions to donor-advised funds are structured as outright gifts to the sponsoring organization (in this case, the community foundation). But the understanding of the parties is that donors, or their designated agents, are given advisory rights which amount to on-going de facto control over the

²⁶ A charity is treated as receiving broad public support if it receives at least one-third of its support from the general public (defined as individuals who have provided less than 2% of the organization's support). RAY D. MADOFF ET AL., PRACTICAL GUIDE TO ESTATE PLANNING (2020).

Community Foundations developed the DAF as a fundraising tool that appealed to donors who wanted to remain involved in advising how their donated funds should be spent. After making a typically large gift a donor could consult with community foundation staff about how best to direct funds for the benefit of the community served. The model was consultative, between donor and institution, and mission focused—grounded by the place-based exempt purpose of the community foundation.

Roger Colinvaux, *Defending Place-Based Philanthropy by Defining the Community Foundation*, 2018 BYU L. REV. 1 (2018).

²⁷ Donor advised funds are legally described in I.R.C. § 4966(d)(2) as

a fund or account: (i) which is separately identified by reference to contributions of a donor or donors, (ii) which is owned and controlled by a sponsoring organization, and (iii) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor.

investment and spending of donated assets.²⁸ As a result of this understanding, donor-advised funds function like charitable checking accounts. The funds remain in the account awaiting instructions from the donor.

The popularity and use of DAFs exploded beginning in 1991 when Fidelity created the first commercial DAF sponsor—Fidelity Charitable. Although Fidelity Charitable adopted the structure of a community foundation, the organization did not purport to stand for any particular charitable purpose—other than the creation of donor-advised funds.²⁹ Commercial DAFs provide another popular means by which private foundations can meet their 5% payout requirement, while still retaining de-facto on-going control over their contributed assets.

Thus, in our above example, if a private foundation is funded with \$10,000,000, it can fully meet its payout requirement by distributing \$500,000 each year to a donor-advised fund where the funds can remain under the foundation's or donor's on-going control, and there are no further payout rules applicable to this fund.

This ability to avoid payout rules by contributing to a donor-advised fund is difficult to justify in light of the temporal logic of the payout rule. Although it is understandable why some private foundations might *want* the flexibility afforded by donor-advised funds, this is different from whether this rule is good policy.

C. Program-Related Investments

Program-related investments (PRIs) represent the latest expansion of the concept of payout. PRIs are similar to grants, but unlike grants, the private foundation expects to get a return of capital and in some cases an investment return on their program-related investment. As explained in one article geared to practitioners, by using PRIs, private foundations can “serve as

²⁸ This disconnect between the legal agreement and the governing understanding of the parties is captured in the statutory definition of donor-advised funds in IRC Section 4966. See I.R.C. § 4966(d)(2).

²⁹ Ryan Macpherson et al., *Donor-Advised Funds: An Underutilized Philanthropic Vehicle to Support Innovation in Science and Engineering*, MIT INNOVATION INITIATIVE 7 (June 2017), https://innovation.mit.edu/assets/MIT-PRIME_DAF.pdf.

venture capitalists by providing seed capital to domestic and foreign for-profit companies, use all manner of creative financial structures (debt, equity, or a combination of both), and take it all into account as ‘qualifying distributions’ for the year.”³⁰ Like administrative expenses, the concept of program-related investments is not without justification—however, the contours of the concept have become so elastic that, depending on how they are structured, program-related investments can allow private foundations to grow their own assets and also grow the wealth of for-profit companies and their shareholders in ways that seem to conflict with the larger purposes of the 5% payout rule.

Program-related investments affect payout rules in two ways: first, a program-related investment can be used to satisfy a private foundation’s 5% payout requirement.³¹ Second, in calculating what that payout requirement is, program-related investments are not counted as part of the foundation’s assets used to calculate the 5% payout requirement.³² For example, a private foundation that has total assets of \$10,000,000, of which \$6,000,000 is invested in program-related investments, need only distribute 5% of \$4,000,000 in order to satisfy its payout requirement. In addition, it can do so by making an additional program-related investment of \$200,000. If a private foundation were to invest all of its assets in “program related investments” it would have no further payout obligations.

Given the powerful effect of program-related investments on payout requirements, it is particularly important to circumscribe the definition of what constitutes a program-related investment in such a way that it ensures that the grants are truly providing a public benefit. Nonetheless, the trend in the law has been to significantly liberalize the scope of program-related investments with no concern of the issues that they might raise.

Based on the legislative history, the original concept of program-related investments was fairly limited to include such investments as low- or no-

³⁰ Ofer Lion & Douglas M. Mancino, *PRIs—New Proposed Regulations and the New Venture Capital*, 24 TAX’N OF EXEMPTS 3, 3 (2012).

³¹ Treas. Reg. § 53.4942(a)-3(a)(2)(i) (as amended in 1986).

³² Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d); Paul Brest, *Investing for Impact with Program Related Investments*, STANFORD SOCIAL INNOVATION (Summer 2016), https://ssir.org/articles/entry/investing_for_impact_with_program_related_investments.

interest loans to needy students or funds for low-income housing and urban renewal.³³ Each of these investments arguably fit comfortably within the notion of funds spent for charitable purpose.³⁴ However, in recent years, changes to the regulations have made clear that the concept of program-related investments has been significantly expanded to include a wide array of traditional investment assets, including equity stakes in for-profit companies.

Program-related investments is a complex issue because these investments can accomplish significant current good. However, because the requirements around PRI's are so lenient, PRI's can also be used simply to divert the foundation's resources into long term investments that provide no meaningful current benefit and allow the foundation to otherwise avoid the 5% payout requirement.

Under the rules, investments must meet three requirements to be treated as a program-related investment.³⁵ First, the investment's primary purpose must be to accomplish one or more of the foundation's charitable purposes.³⁶ To do this, it must both significantly further the foundation's charitable purposes and not have been made but for that achievement. Second, income production must not be a significant purpose for making the investment.³⁷ Third, the investment must not further lobbying or other political activities.³⁸ Because these standards largely focus on the subjective mind-set of the foundation managers (that the investment be made for charitable and not

³³ See J. COMM. ON TAXATION, *supra* note 11, at 46 (“[T]he Act makes it clear that a program-related investment—such as low-interest or interest-free loans to needy students, high risk investments in low-income housing, and loans to small businesses where commercial sources of funds are unavailable—is not to be considered as an investment which might jeopardize the foundation’s carrying out (of its exempt purpose (since such an investment is classified as a charitable expenditure.) To qualify as program related, the investment must be primarily for charitable purposes and not have as one of its significant purposes that of deriving a profit for the foundation.”).

³⁴ Although one might question whether a slightly below-market loan of \$100,000 should receive the same credit for purposes of qualifying distributions as an outright charitable grant of \$100,000 or even as a loan that is significantly below market rate.

³⁵ Treas. Reg. § 53.4944-3(a) (as amended in 2016).

³⁶ *Id.* § 53.4944-3(a)(1)(i).

³⁷ *Id.* § 53.4944-3(a)(1)(ii).

³⁸ *Id.* § 53.4944-3(a)(1)(iii).

investment purposes), these standards provide very little assurance that the program-related investment will accomplish a meaningful charitable purpose.

Since 1972, the governing Treasury Regulation Section 53.4944-3(b) has contained nine examples illustrating investments that qualify as PRIs and one example of an investment that does not qualify as a PRI.³⁹ These long-standing original examples focus on domestic situations principally involving economically disadvantaged individuals and deteriorated urban areas. However, even under these standards, the IRS authorized a variety of different investments in for-profit companies that were deemed to qualify as program-related investments, including investment in a for-profit corporation formed for the purpose of financing and promoting the expansion of environmentally oriented businesses that would contribute to conservation and economic development in economically and/or environmentally sensitive areas. The corporation had dual goals of providing a rate of return and demonstrating a clear environmental benefit through each investment.⁴⁰

In 2012, the Treasury and the IRS proposed to add nine contemporary examples to highlight the broad function and applicability of PRIs as they envisioned them.⁴¹ As attorneys David Levitt and Robert Wexler noted, the Treasury and the IRS appeared to be encouraging foundations to use PRIs in 2012 by proposing to add new examples, all of which describe a case where an investment qualifies as a PRI.⁴² The 2012 proposed regulations were

³⁹ The one example that did not qualify was written so broadly as to provide no guidance at all: “X, a private foundation, invests \$100,000 in the common stock of corporation M. The dividends received from such investment are later applied by X in furtherance of its exempt purposes. Although there is a relationship between the return on the investment and the accomplishment of X’s exempt activities, there is no relationship between the investment per se and such accomplishment. Therefore, the investment cannot be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) and cannot qualify as program-related.” Treas. Reg. § 53.4944-3(a), ex. (7) (as amended in 2016).

⁴⁰ I.R.S. Priv. Ltr. Rul. 20-01-360-26 (Sept. 7, 2001). The IRS concluded that although the foundation expected a financial return, the investment was made directly to accomplish the foundation’s charitable goals and thus qualified as a PRI. David Levitt & Robert Wexler, *Proposed Regulations Would Bring Program-Related Investments Into the 21st Century*, 17 J. TAX’N 100, 109 (2012).

⁴¹ Treas. Reg. § 53.4944-3(a); Examples of Program-Related Investments, 77 Fed. Reg. 76, 23429 (Apr. 19, 2012).

⁴² Treas. Reg. § 53.4944-3(a); Examples of Program-Related Investments, 77 Fed. Reg. 76, 23429 (Apr. 19, 2012); Levitt & Wexler, *supra* note 40, at 109.

finalized in 2016 with some revisions. The regulations now make clear that PRIs can be “loans, acquisitions of stock, a combination of the two, linked deposits, and guarantees” and may be made domestically or in other countries.⁴³

Once an investment qualifies as a program-related investment, a private foundation can retain the investment even if it becomes profitable. For example, a private foundation interested in improving the environment could decide to invest its full \$10,000,000 in plant-based meat alternatives. If the purpose of the investment is to promote the environment and not to make a profit, then it will count for purposes of the foundation’s payout rules (it will also avoid penalty as a jeopardizing investment). The foundation could hold on to that investment for the life of the foundation and fully meet its payout requirements.

One of the challenges to building sensible rules in this area is the fact that the term “program-related investment” for purposes of the payout requirement is borrowed from the rules applicable to “jeopardizing investments.”⁴⁴ The jeopardizing investment rule is designed to discourage foundation managers from making excessively risky investments; and, program-related investments serve as an exception to this rule.⁴⁵ However, the general rule regarding jeopardizing investments has come under some attack recently. Professor Richard Schmalbeck recommends repealing I.R.C. § 4944, on the ground that the rule “impose[s] compliance costs, and may chill investment strategies that would be beneficial for foundations as a whole.”⁴⁶ It is not surprising that there would be broad support for carving out general exceptions, including for program-related investments, given the disfavor with which Schmalbeck and others hold the rules governing jeopardizing investments. Nonetheless, in the context of the satisfying the minimum distribution rule, with its important place in legitimating private foundations, it makes sense to be mindful of the actual charitable impact, rather than just the intent of the board in making these investments.

⁴³ Levitt & Wexler, *supra* note 40, at 109.

⁴⁴ See I.R.C. § 4944.

⁴⁵ Richard Shmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX. L. REV. 59, 66 (2005).

⁴⁶ *Id.* at 108.

III. REFORMING PAYOUT

Private foundation payout rules play an important role legitimating private foundations and providing seeming justification for the significant tax benefits afforded to their donors. However, as discussed in this Article, closer inquiry reveals that payout rules as they are currently drafted operate more as a fig leaf than as a true assurance that private foundations will provide regular public benefit. The ability of private foundations to meet their payout obligations by paying salaries to family members, making distributions to donor-advised funds and investing in program-related investments, all suggest that if payout is going to justify tax benefits, reform is in order.

Some of these reforms are relatively easy and straightforward.

First, payout rules should be reformed to provide that private foundations can no longer meet their payout requirement by paying salaries and other expenses to family members or by making contributions to donor-advised funds. Although both of these are allowed by the letter of current payout rules, they clearly undermine the broader purpose of assuring that private foundation assets provide regular on-going public benefit.

The rule regarding program-related investments qualifying for payout is a more complex one and my proposal here is in tentative form only. While investments can arguably produce public good, the question is whether the investments allowed under the current program-related investment rules provide the same level of good as an outright grant. Current rules are unlikely to assure sufficient public benefit since their focus is on the subjective intent of the foundation managers and not on the actual public benefit provided by the investment. Given the market interest in attracting private foundation funds, the rules should do more to ensure that the public benefit is not being subverted.

One possible answer is to reform the rules to establish some objective metric that assures that program-related investments truly serve public ends at a level that is comparable to charitable grants. Alternatively, the rules governing program-related investments could be modified to provide that program-related investments would no longer serve as a qualifying distributions for purposes of the 5% excise tax but would continue to apply as an exemption from the jeopardizing investment rule. One advantage of this approach is that if we remove program-related investments from qualifying for the payout rule, we can liberalize the definition of program-related investments to take out the requirement that “income production must

not be a significant purpose for making the investment.” This would make it easier for a foundation’s investments to qualify as a program-related investment for purposes of the jeopardizing investment rule, making it easier for private foundations in the investment of “the other ninety-five percent of their assets.”

