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ment is to make interrogatories, already the least expensive discovery device, much more flexible and responsive to the needs of the litigants and more in line with the requirements of a notice pleading system.

RONALD GRAHAM BAKER

### Private Foundations—Redemptions of Excess Business Holdings

The Tax Reform Act of 1969<sup>1</sup> effects a severe regulation<sup>2</sup> of the activities of private foundations.<sup>3</sup> Major among the provisions dealing with foundations is section 4943 of the Internal Revenue Code entitled Taxes on Excess Business Holdings. In essence, this section requires divestiture by the foundation of certain ownership interests in unrelated business enterprises. This comment will explore various avenues open to private foundations for meeting the requirements of section 4943 dealing with excess stock holdings.

The rationale for the approach of the Tax Reform Act to private foundation taxation was stated by the Department of the Treasury as follows:

Generous provisions for tax exemption of private foundations and for the tax deductions of contributions to such foundations have long been provided in the tax laws. However, since this tax treatment diverts amounts from the public treasury to private foundations, it is imperative that the tax laws insure that these private foundations put these funds to philanthropic purposes that benefit the public.<sup>4</sup>

The substance of the new provisions enacted to effectuate this basic policy of control may be summarized as follows:

(1) Self-dealing—direct or indirect transactions between the foundation and major donors or other related parties—is prohibited whether or not the transaction benefits the foundation.<sup>5</sup>

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mitted. However, situations could arise in which an interrogatory which does not relate to an "essential element" should also be permitted.

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1. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 [hereinafter cited as 1969 Act].

2. See, e.g., Bittker, *Should Foundations Be Third-Class Charities?*, in *THE FUTURE OF FOUNDATIONS* 132 (F. Heimann ed. 1973); Labovitz, *1969 Tax Reforms Reconsidered*, in *THE FUTURE OF FOUNDATIONS* 101 (F. Heimann ed. 1973).

3. The term "private foundation" is negatively defined in INT. REV. CODE OF 1954, § 509.

4. *Treasury Department Studies and Proposals*, 6 TAX MANAGEMENT—PRIMARY SOURCES 4941.13 (1973).

5. INT. REV. CODE OF 1954, § 4941; see text accompanying notes 12-22 *infra*.

(2) The assets of the foundation may not be invested in such a way as to jeopardize the charitable purposes of the foundation.<sup>6</sup>

(3) An annual excise tax of four percent of net investment income is imposed on the private foundation.<sup>7</sup>

(4) Foundations are required to spend for charitable purposes an amount equal to net income excluding capital gains.<sup>8</sup>

(5) An excise tax is imposed on any "taxable expenditure" made by the foundation.<sup>9</sup>

(6) The use of foundations to control closely held businesses is restricted by limiting the permissible combined holdings of the foundation and related parties.<sup>10</sup>

### I. SECTION 4943: THE MECHANICS

The House of Representatives posed the problems involved in private foundation ownership of closely held businesses in the following terms:

The use of foundations to maintain control of businesses, particularly small family corporations, appears to be increasing. . . .

Those who wish to use a foundation's stock holdings to retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. Even when the foundation attains a degree of independence from its major donor, there is a temptation for the foundation manager to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable purposes predominate, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the businesses.<sup>11</sup>

The Congressional response to these problems was section 4943.

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6. INT. REV. CODE OF 1954, § 4944.

7. *Id.* § 4940. Net investment income includes capital gains. *Id.*

8. *Id.* § 4942. A minimum investment return is established with a phase-in period for existing foundations. 1969 Act § 101(1)(3); INT. REV. CODE OF 1954, § 4942 (e)(4).

9. INT. REV. CODE OF 1954, § 4945. A "taxable expenditure" is defined as any amount paid or incurred by a foundation (a) to attempt to influence legislation, (b) to influence the outcome of any specific public election or to carry on a voter registration drive, (c) in connection with "a grant to an individual for travel, study, or other similar purposes" unless the individual was chosen "on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary or his delegate," (d) in connection with a grant to other organizations which are themselves private foundations or which do not qualify for exempt status as charities if the giving foundation does not itself insure that the grant is used for charitable purposes. *Id.*

10. *Id.* § 4943.

11. H.R. REP. NO. 413, 91st Cong., 1st Sess. 27 (1969).

To analyze the operation and application of section 4943, it is first necessary to understand two essential concepts—"disqualified person" and "substantial contributor." Section 4946(a) defines a "disqualified person" as a person who is (1) a substantial contributor to the foundation;<sup>12</sup> (2) a foundation manager;<sup>13</sup> (3) a more than twenty percent owner of a corporation, partnership, trust or unincorporated enterprise which is itself a substantial contributor to the foundation;<sup>14</sup> (4) the spouse, ancestor, lineal descendant, or spouse of a lineal descendant of any person in (1), (2), or (3) above;<sup>15</sup> (5) a corporation, partnership, trust, or estate, thirty-five percent of the ownership of which is vested in a person described in (1), (2), (3), or (4) above;<sup>16</sup> or (6) (only for purposes of section 4943) a private foundation "effectively controlled"<sup>17</sup> by those who control the foundation in question<sup>18</sup> or one to which substantially all of the contributions have come from other disqualified persons.<sup>19</sup>

"Substantial contributor," a term central to practically all of the aspects of "disqualified person," is defined by section 507(d)(2)(A) as

any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person.

This basic statutory definition is supplemented by three statutory rules. First, contributions and bequests made before October 9, 1969, are treated as if received on that date.<sup>20</sup> Secondly, an individual is treated as having made all contributions and bequests actually made

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12. INT. REV. CODE OF 1954, § 4946(a)(1)(A); see text accompanying notes 20-22 *infra*.

13. INT. REV. CODE OF 1954, § 4946(a)(1)(B). See *id.* § 4946(b) for the definition of "foundation manager."

14. *Id.* § 4946(a)(1)(C). The corporation ownership requirement is stated in terms of "total combined voting power." *Id.*

15. *Id.* § 4946(a)(1)(D).

16. *Id.* §§ 4946(a)(1)(E)-(H).

17. *Id.* § 4946(a)(1)(H)(i). Treas. Reg. § 53.4946-1(b)(1)(i) (1972) refers to Treas. Reg. § 1.482-1(a)(3), T.D. 6952, 1968-1 CUM. BULL. 218, for the meaning of "effectively controlled." The latter section states that "[i]t is the reality of control which is decisive, not its form or the mode of its exercise." *Id.*

18. INT. REV. CODE OF 1954, § 4946(a)(1)(H)(i).

19. *Id.* § 4946(a)(1)(H)(ii). For purposes of the self-dealing section, a government official is also a disqualified person. *Id.* § 4946(a)(1)(I).

20. *Id.* § 507(d)(2)(B)(ii).

by his spouse.<sup>21</sup> Lastly, "any person who is a substantial contributor on any date shall remain a substantial contributor for all subsequent periods."<sup>22</sup>

The second step in the analysis of section 4943 is the determination of exactly what constitutes "excess business holdings." That term is defined as "the amount of stock or other interest in [a business] enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings of the foundation . . . to be permitted holdings."<sup>23</sup> Permitted holdings, in turn, are deemed to be twenty percent of the voting stock of the enterprise reduced by "the percentage of the voting stock owned by all disqualified persons."<sup>24</sup> This twenty percent ceiling rises to thirty-five percent if no more than thirty-five percent of the voting stock of the enterprise is owned by the foundation and all disqualified persons, and also if the Commissioner is satisfied that effective control is in one who is not a disqualified person vis-a-vis the foundation.<sup>25</sup>

The Code employs three distinct levels of taxation to insure the absence of excess business holdings. First, an excise tax equal to five percent of the value of the excess business holdings is imposed at the end of any taxable year during which the private foundation had excess holdings.<sup>26</sup> Secondly, an excise tax equal to two hundred percent of the value of the excess business holdings is imposed at the end of the correction period (normally ninety days from the notice of deficiency and imposition of the five percent tax) if the private foundation still has excess business holdings.<sup>27</sup> Lastly, private foundation status may be terminated if "there have been either willful repeated acts (or fail-

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21. *Id.* § 507(d)(2)(B)(iii).

22. *Id.* § 507(d)(2)(B)(iv).

23. *Id.* § 4943(c)(1). Section 4943(d)(4) defines business enterprise to exclude "a trade or business at least 95 percent of the gross income of which is derived from passive sources." *Id.* § 4943(d)(4)(B). Also excluded is a functionally related business. *Id.* § 4943(d)(4)(A); see *id.* §§ 513, 4942(j).

24. *Id.* § 4943(c)(2)(A). Although this comment will focus on corporate ownership interests proscribed by section 4943, it should be noted that noncorporate ownership interests are also within the purview of the section. See *id.* § 4943(c)(3).

For purposes of section 4943(c), non-voting stock is treated as permitted holdings if all disqualified persons together do not own more than 20% of the voting stock. *Id.* § 4943(c)(2)(A) (last sentence). A further qualification is the "2% de minimis rule" which declares that if a foundation owns no more than 2% of the voting power or 2% of the total value of stock outstanding, such holding will never be an excess business holding. *Id.* § 4943(c)(2)(C).

25. *Id.* § 4943(c)(2)(B).

26. *Id.* §§ 4943(a)(1)-(2). The tax shall be determined as of the day during the taxable year when the holdings were the greatest. *Id.* § 4943(a)(2)(B).

27. *Id.* § 4943(b).

ures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42.”<sup>28</sup> The tax imposed upon termination is the lesser of the “aggregate tax benefit” to the foundation and its substantial contributors which is attributable to the foundation’s section 501(c)(3) status<sup>29</sup> or the value of the net assets of the foundation.<sup>30</sup>

These three levels of taxation, however, do not necessarily come into play whenever the foundation has excess business holdings; rather section 4943(c), sets up grace periods or grandfather clauses and, in certain cases, modifies the percentage levels for permitted holdings. The key date for grace period purposes is May 26, 1969. After this date a change in the holdings of a private foundation (other than by purchase)<sup>31</sup> that causes the foundation to have excess business holdings will not render the foundation liable for the excess business holdings tax until the expiration of the five year period beginning on the date of such change. Even then, liability arises only if the foundation has not disposed of the “new” stock before the expiration of the five year period.<sup>32</sup>

A different rule applies with respect to “present holdings” which are defined as ownership interests held by the foundation and disqualified persons on May 26, 1969.<sup>33</sup> In determining the permitted holding percentage<sup>34</sup> for present holdings, the actual percentage held is substituted for the normal limit of twenty percent but in no case may the percentage be greater than fifty percent.<sup>35</sup> The grace period for

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28. *Id.* § 507(a)(2)(A); see Treas. Reg. § 1.507-1(c) (1972).

29. INT. REV. CODE OF 1954, §§ 507(c)(1), (d)(1).

30. *Id.* § 507(c)(2).

31. *Id.* § 4943(c)(6). This requirement includes purchase both by the foundation and any disqualified person.

32. *Id.* § 4943(c)(6)(A). The statutory phrasing is: “the interest of the foundation in such enterprise (immediately after such change) shall (while held by the foundation) be treated as held by a disqualified person (rather than by the foundation) during the 5-year period beginning on the date of such change in holdings.” *Id.*

33. *Id.* § 4943(c)(4). Also deemed to be present holdings are stock acquired pursuant to a trust irrevocable on May 26, 1969, and under the terms of a will executed on or before May 26, 1969, and thereafter unchanged with respect to the bequest of stock. *Id.* § 4943(c)(5).

34. See text accompanying notes 23-25 *supra*.

35. INT. REV. CODE OF 1954, § 4943(c)(4)(A)(i). This provision has a ratchet like effect that can be quite troubling to the foundation. For example, suppose that a private foundation (PF) on May 26, 1969, holds, together with all disqualified persons, 40% of the voting stock of X Co. In 1975, if D, a disqualified person, were to sell stock amounting to 2%, the substitute percentage would decrease to 38%. A subsequent purchase of 2% by D or another disqualified person does not return the substitute percentage to 40% but rather renders PF liable for the initial level tax under section

present holdings varies according to the percentage held: (1) if the foundation and disqualified persons hold more than ninety-five percent of the voting stock, the grace period is twenty years;<sup>36</sup> (2) except as provided in (1), if the foundation and disqualified persons hold more than seventy-five percent of the voting stock or more than a seventy-five percent interest in all outstanding stock, the grace period is fifteen years;<sup>37</sup> (3) in any other case the grace period is ten years.<sup>38</sup>

The fifty percent level for permitted holdings substituted during the grace periods, however, is not necessarily the permanent maximum for present holdings. If, during the second phase—the fifteen-year period following the grace period—all disqualified persons together own more than two percent of the voting stock of the enterprise, the permitted percentage is changed to “50 percent, of which not more than 25 percent shall be voting stock held by the private foundation.”<sup>39</sup> Even if this twenty-five percent limitation does not apply during the second phase, if at any future time all disqualified persons own more than two percent of the voting stock of a business enterprise, the foundation may own no more than twenty-five percent and the foundation and all disqualified persons together may own no more than thirty-five percent.<sup>40</sup> Holdings in excess of the appropriate limits during or after the second phase triggers immediate imposition of the initial five percent level of taxation.<sup>41</sup>

## II. REDEMPTION OF EXCESS BUSINESS HOLDINGS

One commentator, who has surveyed foundation reaction to the Tax Reform Act of 1969, reported that although foundations are troubled about the ultimate effect of section 4943, the generous grace periods have attenuated any immediate concern. Furthermore, some foundation managers apparently hope for a “more sympathetic Congress or corporate expansion [that would] make divestiture unneces-

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4943(a). See Plumb, *Avoiding the 200% Tax on Excess Holdings for 20 to 50%-owned Private Foundations*, 34 J. TAX. 296 (1971).

36. INT. REV. CODE OF 1954, § 4943(c)(4)(B)(i) (holdings treated as though held by a disqualified person).

37. *Id.* § 4943(c)(4)(B)(ii). This provision encompasses a “profits or beneficial interest” in an unincorporated enterprise as well as stock interests in a corporation.

38. *Id.* § 4943(c)(4)(B)(iii).

39. *Id.* § 4943(c)(4)(D)(i); Proposed Treas. Reg. § 53.4943-4(c)(2)(b)(ii), 38 Fed. Reg. 39 (1973).

40. INT. REV. CODE OF 1954, § 4943(c)(4)(D)(ii); Proposed Treas. Reg. § 53.4943-4(d)(2)(b)(ii), 38 Fed. Reg. 40 (1973).

41. INT. REV. CODE OF 1954, §§ 4943(a), (c)(4)(D).

sary."<sup>42</sup> In spite of this inaction by many foundations, the more realistic course would be at least consideration of, if not planning for, divestiture or some other means of compliance with section 4943.

The most attractive avenue to avoid the penalty taxes would seem to be redemption;<sup>43</sup> specifically the corporation whose stock constitutes excess business holdings in the hands of the private foundation may redeem some or all of that stock. Redemption is an especially useful tool in this situation because the corporation may exchange appreciated property for the stock constituting excess business holdings and not recognize gain on the transfer.<sup>44</sup> In addition, by using the redemption method, the shareholders of the corporation other than the foundation may more easily retain their relative equity positions<sup>45</sup> than would be the case if the method used were divestiture through direct sale to a third person.<sup>46</sup> As long as the redeeming corporation is not a disqualified person vis-a-vis the private foundation, the normal redemption procedures will be applicable.<sup>47</sup>

The usefulness of redemption in an excess business holdings situation, however, is vitiated to a certain extent by the self-dealing rules of section 4941. If the redeeming corporation is a disqualified person vis-a-vis the private foundation, a redemption transaction will normally be an "act of self-dealing"<sup>48</sup> subjecting the foundation manager and the disqualified person to penalty taxes.<sup>49</sup> In spite of the redeeming corporation's status as a disqualified person, the tax law provides sev-

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42. Labovitz, *supra* note 2, at 115-16.

43. Another avenue to avoidance of the penalty taxes is one in which the foundation sheds its status as a private foundation. See Weithorn, *How to Change Private Foundation Status by Voluntary "Termination" or by "Public Conversion"*, N.Y.U. 11TH BIENNIAL CONF. ON CHARITABLE FOUNDATIONS 219 (1973). See also Bolton, *What Should a Private Foundation Do to Meet the New Rules of the 1969 Tax Reform Act*, N.Y.U. 29TH INST. ON FED. TAX. 2083 (1971); Moorehead, *Private Foundations and Public Charities: Handling Definitional Problems Under the Tax Reform Act*, N.Y.U. 31ST INST. ON FED. TAX. 1267 (1973); Wagner, *Private Foundations Still Have a Place in Planning to Save Taxes*, 2 TAXATION FOR LAWYERS 38 (1973).

44. See INT. REV. CODE OF 1954, §§ 302, 311(d)(2)(A), (F).

45. The unredeemed shareholders will also emerge from the redemption with a relatively greater proportion of the equity than would be the case in sale to third parties.

46. See Geske, *Excess Business Holdings Can Be Disposed of to Disqualified Persons Without Penalty*, 41 J. TAX. 296 (1974).

47. INT. REV. CODE OF 1954, § 302.

48. *Id.* § 4941(d)(1)(A) defines self-dealing as, *inter alia*, any direct or indirect "sale or exchange . . . of property between a private foundation and a disqualified person." Section 302(a) states that a qualifying "redemption shall be treated as a distribution . . . in exchange for the stock."

49. *Id.* §§ 4941(a)-(b). Basically, the tax on the disqualified person is 5% of the amount involved in the transaction and the tax on the foundation manager is 2.5%. *Id.*



eral narrow openings for redemptions that will not be acts of self-dealing. The most specific provisions are section 4941(d)(2)(F) of the Internal Revenue Code and sections 101(1)(2)(B) and (C) of the Tax Reform Act of 1969.

#### A. Removal of "Disqualified Person" Status

In planning a redemption that will avoid self-dealing problems, the initial inquiry should seek to determine what makes the corporation a disqualified person and then, whether that status can or should be removed.<sup>50</sup> If the corporation is itself a substantial contributor to the foundation,<sup>51</sup> it will remain a substantial contributor and thus a disqualified person "for all subsequent periods."<sup>52</sup> If the redeeming corporation itself is not a substantial contributor, but more than thirty-five percent of its ownership is in the hands of persons who are (1) substantial contributors,<sup>53</sup> (2) foundation managers,<sup>54</sup> (3) twenty percent owners of substantial contributor corporations, or (4) members of the family of any one of the above three,<sup>55</sup> disqualified person status can be re-

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50. A related approach is to redeem all or part of the ownership interests of the disqualified persons. The approach poses no self-dealing problems and may serve to reduce the combined holdings to within the permitted level. There are two major aspects of this approach which merit cautionary mention. First, such a redemption will serve to increase the foundation's percentage of the outstanding equity. Secondly, a later repurchase by the disqualified person may trigger automatic imposition of the 5% level of taxation. *Id.* § 4943(c)(6).

51. *Id.* §§ 4946(a)(1)(A), 507(d)(2); see text accompanying notes 20-22 *supra*.

52. INT. REV. CODE OF 1954, § 507(d)(2)(B)(iv). The regulations do not meet the question of whether the corporation's termination as part of a corporate reorganization will terminate its status as a substantial contributor. The regulations under section 4943, though, do comment on the analogous problem of treatment of stock received by the private foundation in a reorganization in exchange for stock constituting excess business holdings. In general, the new stock is substituted for the old. Proposed Treas. Reg. § 53.4943-4(f), 38 Fed. Reg. 41-43 (1973).

53. In analyzing this 35% stock ownership requisite, constructive ownership rules similar to those of section 267(c) must be taken into account. INT. REV. CODE OF 1954, §§ 267(c), 4946(a)(3); see Treas. Reg. §§ 53.4946-1(a)(5), -1(d) (1972). The Code and regulations modify the rules of section 267(c) in the following respects: brothers and sisters are excluded but spouses of lineal descendants are included. INT. REV. CODE OF 1954, § 4946(d); Treas. Reg. §§ 53.4946-1(d)(1)(i), -1(h) (1972). "Any stockholdings which have been counted once (whether by reason of actual or constructive ownership) in applying section 4946(a)(1)(E) shall not be counted a second time." *Id.* § 53.4946-1(d)(iii). An individual deemed, pursuant to section 267(c)(2), constructively to own stock actually owned by members of his family will not be treated as owning it for purposes of section 4946(a)(1)(E) (the 35% test) if he is not himself a substantial contributor, foundation manager, or 20% owner of a substantial contributor. *Id.* § 53.4946-1(d)(1) (last sentence).

54. See INT. REV. CODE OF 1954, § 4946(b). Note that the foundation manager of one foundation is not necessarily a disqualified person vis-a-vis foundations other than the one he serves.

55. *Id.* § 4946(a)(1)(E).

moved if enough ownership is shifted into the hands of unrelated third parties. Even though shedding disqualified person status is probably the simplest way to clear the path for redemption, it suffers in that the present owners of the redeeming corporation may be quite reluctant to sell stock to a third party.

### B. Section 4941(d)(2)(F)

Even if it is not feasible to remove the corporation's disqualified person status, and thus completely remove the threat of self-dealing, redemption as an avenue to divestiture may not be foreclosed. One possible approach is to take advantage of the dispensation provided by section 4941(d)(2)(F). That section provides, in pertinent part, that a redemption between a private foundation and a corporation which is a disqualified person shall not be an act of self-dealing if (1) all shareholders of the same class of stock as that redeemed from the foundation are offered the same consideration for each share and (2) the terms of the redemption are otherwise the same for all shareholders of that class.<sup>56</sup> This section recognizes the occasional necessity of reorganization of structure but limits the opportunity for penalty-free treatment to situations in which aid to the foundation is not the dominant motive. One commentator indicated that the practical vitality of this section as a means of accomplishing divestiture of excess business holdings is limited largely to the situation in which the foundation is the sole owner of the class of stock redeemed.<sup>57</sup> For instance, if the excess business holdings of the foundation consist of all of the class B voting common, a section 302(b)(3) termination of shareholder's interest<sup>58</sup> would qualify for the dispensation if the terms of the redemption provide for receipt by the foundation of no less than fair market value.<sup>59</sup>

### C. Section 101(1)(2)(B)

Another and more useful dispensation from the strictures of the self-dealing rules is provided by section 101(1)(2)(B) of the Tax Reform Act of 1969.<sup>60</sup> This section provides that a redemption of present holdings between a private foundation and a disqualified person will

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56. *Id.* The transactions included within the purview of this provision are "liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization." *Id.*

57. Geske, *supra* note 46, at 296-97.

58. INT. REV. CODE OF 1954, § 302(b)(3); *see id.* § 311(d)(2)(A).

59. *Id.* § 4941(d)(2)(F).

60. *See* Treas. Reg. § 53.4941(d)-4(b) (1973).

not be an act of self-dealing if the foundation is "required to dispose" of the stock in order to avoid taxation under section 4943 and the foundation receives an amount which is equal to or greater than the fair market value of the stock redeemed.<sup>61</sup>

The first problem in utilizing section 101(1)(2)(B) is the ascertainment of the meaning of the phrase "required to dispose". Before January 1975 the foundation is "required to dispose" of that stock held by it and all its disqualified persons in excess of the twenty percent limitation of section 4943(c)(2). Presumably, section 101(1)(2)(B) may not be used to drop the combined holdings below twenty percent since, once the twenty percent level is reached, the foundation is no longer required to dispose of any stock.<sup>62</sup> After December 31, 1974, section 101(1)(2)(B) indicates that section 4943(c)(4) must be considered in determining the amount that must be disposed.<sup>63</sup> Two readings are possible. First, since subsection (c)(4) sets up statutory grace periods,<sup>64</sup> no stock is required to be disposed of until the end of the applicable grace period. Accordingly, section 101(1)(2)(B) would not authorize a redemption until the end of the grace period. This, however, would be an unfortunate interpretation since the tax of section 4943 is triggered by an excess business holding even though it is present only for one minute after the expiration of the grace period.<sup>65</sup> In other words, after December 31, 1974, this exception to the self-dealing rules will aid only those foundations which have been taxed at the first level and have moved into the correction period,<sup>66</sup> a circumstance that will not be present with respect to present holdings until May 26, 1979. The second and better interpretation would be that subsection (c)(4) should be employed to determine the percentage below which the combined holdings may not be reduced and not the time be-

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61. 1969 Act § 101(1)(2)(B).

62. *Id.*; Treas. Reg. § 53.4941(d)-4(b) (1973); see INT. REV. CODE OF 1954, § 4943(c)(4). But see Geske, *supra* note 46, at 298; cf. Gerber, *Proposed Regs Detail Rules for Tax on Self-dealing with Private Foundations*, 35 J. TAX. 142, 145 (1971). These two commentators seize on the fact that the *de minimis* rule of section 4943(c)(2)(C) is to be ignored when computing the amount which the foundation is "required to dispose" and imply that in all situations the foundation may dispose of all of its stock. The proper reading would appear to be that when the combined holdings are more than 20%, the foundation may dispose of all of its stock but not if combined holdings are less. For instance, if the disqualified persons own 50% and the foundation 5%, all of the 5% may go even though the last 2% will never be excess business holdings.

63. 1969 Act § 101(1)(2)(B); Treas. Reg. § 53.4941(d)-4(b)(1).

64. See text accompanying notes 33-41 *supra*.

65. INT. REV. CODE OF 1954, § 4943(a)(2)(B).

66. *Id.* §§ 4943(a)(1), (b), (d)(3).

fore which the holdings must be disposed. Such a reading would, in general, dictate that the transaction could not reduce the combined holdings below fifty percent.<sup>67</sup> Pursuant to this interpretation, stock that represents the holdings above fifty percent may be redeemed during the grace period after January 1, 1975.

If the redeeming corporation is closely held or if the consideration for the redemption does not have a readily ascertainable market value, the provision in section 101(1)(2)(B) that requires the foundation to receive an amount "which equals or exceeds the fair market value" of the stock surrendered will cause serious problems for corporations and foundations contemplating redemption. The regulations<sup>68</sup> provide that valuations must be made in accordance with principles promulgated in the regulations under section 2031<sup>69</sup> that require a fair appraisal of all of the assets of the business, including good will.<sup>70</sup> Revenue Ruling 59-60, which delineates in some detail the factors to be considered in appraising a closely held business,<sup>71</sup> states that

No formula can be devised that will be generally applicable to the multitude of different valuation issues . . . . Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.<sup>72</sup>

The Commissioner's recognition of the difficulties involved in valuation is further evidenced in the construction given the term "amount involved"<sup>73</sup> in the regulations under section 4941.<sup>74</sup> These regulations provide that if (1) the appraiser is not a disqualified person, is compet-

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67. *Id.* § 4943(c)(4)(A)(i); see *id.* §§ 4943(c)(4)(D)(i)-(ii) which seem to indicate that the private foundation's holdings may not be reduced below 25%.

68. Treas. Reg. §§ 53.4941(e)-1(f), 53.4942(a)-2(c)(4)(iv)(c) (1973).

69. *Id.* § 20.2031-3 (1958).

70. *Id.*

71. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237. This ruling has been termed "[o]ne of the principal guidelines used today in determining corporate values." Vass, *Factors That Are Presently Being Emphasized in Valuing a Closely-held Corporation*, 38 J. TAX. 356 (1973).

72. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237, 238. The ruling also makes the point that "[t]he value of shares of stock of a company with very uncertain future prospects is highly speculative." *Id.*

73. INT. REV. CODE OF 1954, § 4941(e). The statute provides that the amount involved shall be the greater of the fair market value of property given or the fair market value of property received.

74. Treas. Reg. § 53.4941(e)-1(b) (1973).

ent, and is not in a position to profit from the value utilized and (2) a generally accepted method of valuation is employed, the parties will be deemed to have made a good faith effort to determine fair market value.<sup>75</sup> In such a case, "the amount involved is the excess of the fair market value of the property transferred by the private foundation over the amount which the private foundation receives."<sup>76</sup> The consequence of this leniency is twofold. First, the initial self-dealing tax is only five percent of the error in valuation rather than five percent of the total fair market value of the redeemed stock.<sup>77</sup> Secondly, correction, which is required to avoid the second-level tax, may be accomplished by payment to the foundation of the amount involved plus interest,<sup>78</sup> rather than by returning the parties to status quo ante.<sup>79</sup>

Although the initial self-dealing taxes may be viewed by the corporation as a reasonable cost of the redemption, the valuation requirements of section 101(1)(2)(B) do pose the threat of severe penalties for the redeeming corporation through their interaction with section 311(d)(2)(F). Section 311(d)(2)(F) provides a non-recognition path for redemptions from foundations when the consideration for the redemption is appreciated property. The stock that may be redeemed is that stock constituting "excess business holdings redemption needs of the business"<sup>80</sup> as "described in sections 537(b)(2)(A) and (B)."<sup>81</sup>

This provision for redemption of excess business holdings originated as a Senate amendment to the House bill which later became the Tax Reform Act of 1969.<sup>82</sup> The Senate Finance Committee in its report described the motivation for the amendment as follows:

The Internal Revenue Service sometimes has taken the position that any large redemption of stock indicates that the corporation had funds available for non corporate purposes and therefore this is evidence that earnings were accumulated beyond the reasonable needs of the business. . . .

The committee believes that . . . amounts accumulated to redeem stock which constitutes an excess business holding in the hands of a foundation should not be considered unreasonable ac-

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75. *Id.* §§ 53.4941(e)-1(b)(2)(iii)(a)-(b).

76. *Id.* § 53.4941(e)-1(b)(2)(iii).

77. INT. REV. CODE OF 1954, § 4941(a).

78. Treas. Reg. § 53.4941(e)-1(c)(7) (1973).

79. INT. REV. CODE OF 1954, § 4941(e)(1).

80. *Id.* § 537(a)(3).

81. *Id.* § 311(d)(2)(F); see *id.* §§ 4943(c)(4), (5).

82. H.R. REP. NO. 91-782, 91st Cong., 1st Sess. 333.

cumulations. To consider [them] as such would substantially interfere with the purpose of [section 101(1)(2)(B)].<sup>83</sup>

Unfortunately, the regulations do not completely effectuate the congressional purpose of protecting redemptions under section 101(1)(2)(B) and, indeed, they severely impair the attractiveness of this dispensation from the self-dealing rules. The troublesome provision is section 1.537-1(d)(5) that states: "[A]n excess business holdings redemption need will not be deemed to exist with respect to stock held by a private foundation the redemption of which would subject any person to tax under section 4941."<sup>84</sup> Thus a good faith error in valuation that will subject the corporation to self-dealing tax<sup>85</sup> will also render the amounts accumulated for the redemption unreasonable, thus triggering the accumulated earnings tax.<sup>86</sup>

In addition, this provision in the regulations under section 537 may also remove the redemption from the protection of section 311(d)(2)(F) if the self-dealing tax were imposed. It is possible that, when the redemption is deemed not to be a reasonable need of the business because of section 4941 taxation, the stock redeemed may be viewed as not the stock for which the benefit of section 311(d)(2)(F) was designed, thus relegating the redemption to the sale or exchange treatment of section 311(d).<sup>87</sup> By the literal terms of the statute, however, the stock redeemed would still seem to be *described* in sections 537(b)(2)(A) and (B) regardless of the mechanics of the transaction.<sup>88</sup> Nevertheless, it is arguable that the regulatory condition should be consistent in both sections 311(d)(2)(F) and 537.<sup>89</sup>

Two recent commentators pose a hypothetical that clearly demonstrates the harshness of the valuation dilemma.<sup>90</sup> Assume for example that in 1974 a corporation redeemed its stock from a private foundation for twenty million dollars (a value established by independent appraisers). The consideration was five million dollars cash accumulated for this purpose and fifteen million dollars property with an adjusted basis of ten million dollars. As the result of an audit in 1976, the Commis-

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83. S. REP. NO. 91-552, 91st Cong., 1st Sess. 279-80.

84. Treas. Reg. § 1.537-1(d)(5), T.D. 7165, 1972-1 CUM. BULL. 167.

85. See text accompanying notes 73-79 *supra*.

86. INT. REV. CODE OF 1954, §§ 531-33.

87. See Hasson & Duffney, *Are Redemptions of Stock by Private Foundations Being Blocked by Regs?*, 40 J. TAX. 300, 302 (1974).

88. INT. REV. CODE OF 1954, § 311(d)(2)(F).

89. See Hasson & Duffney, *supra* note 87, at 302.

90. *Id.* at 300-01.

91. (5%) (4 years) (\$2 million) = \$400,000.

sioner determined in 1977 that a ten percent error in valuation had been made—that the stock redeemed was worth twenty-two million dollars. The initial self-dealing taxes are 400,000 dollars plus interest.<sup>91</sup> The accumulated earnings tax is approximately 1.8 million dollars. At a capital gains rate of thirty percent, the section 311(d) tax is 1.5 million dollars. Thus, for a two million dollar good faith valuation error, the taxes are over 3.5 million dollars.

Section 311(d)(2)(A) also provides an avenue for redemption of excess business holdings from the foundation in return for appreciated property. This section excepts from gain recognition:

a distribution in complete redemption of all of the stock of a shareholder who, at all times within the 12-month period ending on the date of such distribution, owns at least 10 percent in value of the outstanding stock of the distributing corporation, but only if the redemption qualifies under section 302(b)(3) (determined without the application of section 302(c)(2)(A)(ii)).<sup>92</sup>

Two aspects of the required qualification under section 302(b)(3) should be noted. First, the family attribution rules of section 318(a)(1)<sup>93</sup> may be waived if the foundation retains no interest in the corporation other than as a creditor.<sup>94</sup> Secondly, if the attribution rules do not pose a problem, then the interest terminated need only be the foundation's stock interest.<sup>95</sup> Care should be exercised, however, to avoid the possibility that any debt given in the redemption will be considered to be an evidence of proprietary interest rather than debt.<sup>96</sup>

Of additional concern are the requirements under section 311(d)(2)(A) that the foundation be a ten percent shareholder who has held his interest for the twelve months preceding the redemption.<sup>97</sup> The regulations indicate that the section 1223 holding period rules apply in qualification for the twelve-month holding requirement.<sup>98</sup> In addi-

92. *Id.*

93. *Id.* § 318(a)(1); see Bacon, *Corporate Stock Redemption—Basic Rules*, 17-5th TAX MANAGEMENT PORTFOLIO A25-34 (1973).

94. INT. REV. CODE OF 1954, §§ 311(d)(2)(A), 302(b)(3), (c)(2). The effect of not considering subpart (ii) would seem to mandate not considering subpart (iii) as well, since the latter pertains solely to enforcement of the former.

95. *Id.* § 302(b)(3); B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 9.23 (student ed. 1971). It should also be noted that a combination redemption and sale to a third party may be successful in accomplishing the complete termination. *Id.* ¶¶ 9.23, .25; Bacon, *supra* note 93, at A41; see *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); Treas. Reg. § 1.311-2(b)(1) (1972).

96. Bacon, *supra* note 93, at A24.

97. INT. REV. CODE OF 1954, § 311(d)(2)(A).

98. Treas. Reg. § 1.311-2(b)(2) (1972).

tion, a sale and redemption that are substantially contemporaneous and are pursuant to a plan of redemption shall be treated as simultaneous for purposes of qualification as a ten percent shareholder.<sup>99</sup>

Thus section 311(d)(2)(A) can be used in conjunction with section 101(1)(2)(B) of the Tax Reform Act of 1969 to both spare gain recognition to the redeeming corporation and avoid self-dealing taxes. Although the valuation issue is present when section 311(d)(2)(A) is the mechanism chosen for the redemption, a valuation error triggering imposition of the accumulated earnings tax should not force recognition of gain on the redeeming corporation as it may when section 311(d)(2)(F) is chosen.<sup>100</sup>

#### D. Section 101(1)(2)(C)

The redeeming corporation may desire to exchange debt rather than appreciated property for the stock in the hands of the private foundation. This should pose no problem for the corporation that is not a disqualified person vis-a-vis the foundation as long as the debt is adequately secured.<sup>101</sup> However, if the corporation is a disqualified person, the transfer of the debt instruments will constitute an act of self-dealing under section 4941(d)(1)(B) ("lending of money or other extension of credit"). Notwithstanding this general prohibition, section 101(1)(2)(C) of the Tax Reform Act of 1969 permits a limited dispensation in the case of extensions of credit "pursuant to a binding contract which was in effect on October 9, 1969."<sup>102</sup> In addition, the regulations under section 4941 provide that in the case of redemptions otherwise qualifying for self-dealing dispensation,<sup>103</sup> the issuance of bonds or other indebtedness of disqualified persons "shall be treated as an extension of credit pursuant to a binding contract in effect on October 9, 1969."<sup>104</sup>

Qualification for the dispensation of section 101(1)(2)(C) is conditioned on the meeting of two criteria. First, the transaction must not be a prohibited transaction under section 503(b).<sup>105</sup> The import of

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99. *Id.* § 1.311-2(b)(1).

100. See text accompanying notes 80-89 *supra*.

101. INT. REV. CODE OF 1954, § 503(b); Treas. Reg. § 1.503(c)-1(b)(1), T.D. 6301, 1958-2 CUM. BULL. 197.

102. Treas. Reg. § 53.4941(d)-4(c)(1) (1973).

103. *Id.* §§ 53.4941(d)-3, -4(a)-(b).

104. *Id.* § 53.4941(d)-4(c)(4).

105. *Id.* § 53.4941(d)-4(c)(1)(i); see INT. REV. CODE OF 1954, § 503(b)(1).



this condition is that "adequate security"<sup>106</sup> must accompany the extension of credit. Secondly, the extension of credit must remain, throughout its term, "at least as favorable as a current arm's-length transaction with an unrelated person."<sup>107</sup> If the extension of credit becomes less favorable to the foundation than an arms-length contract negotiated currently, it will be deemed an act of self-dealing unless the variation is *de minimis*<sup>108</sup> or the debt is renegotiated so that the foundation receives at least fair market value.<sup>109</sup>

This relief from the self-dealing rules, however, only extends through 1979, since bonds issued as consideration for a redemption qualifying under section 101(1)(2)(B) will become subject to the general self-dealing provision on the first day of 1980.<sup>110</sup> Nevertheless, it may be desirable to issue bonds with a longer maturity contemplating sale to third persons before 1980. This pattern is also appealing because equity interests would not be transferred to third parties, a frequent concern for owners of closely held corporations.<sup>111</sup>

Debt obligations as consideration for the redemption of excess business holdings would be particularly attractive to the closely held corporation without sufficient property to fully compensate the foundation at the outset. The problem in issuing debt in exchange for the stock held by the foundation lies primarily in the continuing obligation to insure that the foundation receives fair market value. Presumably, this requirement would be met by a variable interest rate keyed to an accepted indicator of interest rates.

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106. The regulations define "adequate security" as something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise be disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may be reasonably anticipated that loss of principal or interest will not result from the loan. . . . Stock of a borrowing corporation does not constitute adequate security.

Treas. Reg. § 1.503(c)-1(b), 1958-2 CUM. BULL. 197.

107. *Id.* §§ 53.4941(d)-4(c)(1)(ii), -4(c)(4) (1973).

108. *Id.* § 53.4941(d)-4(c)(2)(i). "De minimis" is defined as no more than .5% in the rate of return on the indebtedness. *Id.* § 53.4941(d)-4(c)(2).

109. *Id.* § 53.4941(d)-4(c)(2)(ii).

110. *Id.* § 53.4941(d)-4(c)(4).

111. Geske, *supra* note 46, at 300. Mention should also be made of the possibility of issuing convertible debt as consideration for the redemption. The attractiveness of this form lies in its potential for protecting family control of the enterprise. The use of convertible debt, however, would seem to be severely limited because of its ineligibility when used in connection with a complete termination of the shareholder's interest. INT. REV. CODE OF 1954, §§ 302(b)(3), 311(d)(2)(A), 318(a)(4); Rev. Rul. 68-601, 1968-2 CUM. BULL. 124. Furthermore, when used with a section 302(b)(2) redemption, the convertible debt will count as stock for purposes of meeting the percentage tests. Bacon, *supra* note 93, at A14; see Rev. Rul. 68-601, *supra*.