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PHILANTHROPIC ENTERPRISE ACT OF 2015

APRIL 14, 2015.—Ordered to be printed

Mr. HATCH, from the Committee on Finance,  
submitted the following

**R E P O R T**

[To accompany S. 909]

The Committee on Finance, having considered an original bill, S. 909, to amend the Internal Revenue Code of 1986 to exempt private foundations from the tax on excess business holdings in the case of certain philanthropic enterprises which are independently supervised, and for other purposes, having considered the same, reports favorably thereon without amendment and recommends that the bill do pass.

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**I. LEGISLATIVE BACKGROUND**

The Committee on Finance, having considered S. 909, the “Philanthropic Enterprise Act of 2015,” to amend the Internal Revenue Code of 1986 to exempt private foundations from the tax on excess business holdings in the case of certain philanthropic enterprises which are independently supervised, and for other purposes, reports favorably thereon without amendment and recommends that the bill do pass.

*Background and need for legislative action*

*Background.*—Based on a proposal recommended by Senators Thune and Menendez, and on section 2 of S. 2710 (113th Cong., 2d Sess.), co-sponsored by Senators Thune and Menendez, the Committee on Finance marked up original legislation (the “Philanthropic Enterprise Act of 2015”) on February 11, 2015, and, with a majority present, ordered the bill favorably reported.

*Need for legislative action.*—In recent years, a new type of philanthropy has combined private sector entrepreneurship with charitable giving, such as through the donation of a private company’s after-tax profits to charity. The Committee believes it is appropriate to encourage this form of philanthropy by eliminating certain legal impediments to its use, while also ensuring that private individuals cannot improperly benefit from charitable dollars. The Committee therefore believes it is appropriate to create an exception to the present-law private foundation excess business holdings rules for certain philanthropic business holdings. By so doing, the law will permit private philanthropists to bequeath an entire business to a private foundation, provided that the after-tax profits of the business will be paid to the foundation and certain other requirements are satisfied, while also ensuring that the donor’s heirs cannot improperly benefit from the arrangement.

## II. EXPLANATION OF THE BILL

### A. PROVIDE AN EXCEPTION TO THE PRIVATE FOUNDATION EXCESS BUSINESS HOLDINGS RULES FOR CERTAIN PHILANTHROPIC BUSINESS HOLDINGS (SEC. 2 OF THE BILL AND SEC. 4943 OF THE CODE)

#### PRESENT LAW

##### *Public charities and private foundations*

An organization qualifying for tax-exempt status under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “Code”) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.<sup>1</sup> Certain organizations are classified as public charities per se, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations (including medical research organizations), certain organizations providing assistance to colleges and universities, and governmental units.<sup>2</sup> Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.<sup>3</sup> Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (e.g., fee for service income). In addition, this category of

<sup>1</sup>The Code does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

<sup>2</sup>Sec. 509(a)(1) (referring to sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>3</sup>Treas. Reg. sec. 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a “facts and circumstances” test. Treas. Reg. sec. 1.170A-9(f)(3).

public charity must not rely excessively on endowment income as a source of support.<sup>4</sup> A supporting organization, i.e., an organization that provides support to another section 501(c)(3) entity that is not a private foundation and meets certain other requirements of the Code, also is classified as a public charity.<sup>5</sup>

A section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (e.g., an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities, as well as a tax on their net investment income.<sup>6</sup>

#### *Excess business holdings of private foundations*

Private foundations are subject to tax on excess business holdings.<sup>7</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (substituting “profits interest” for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.<sup>8</sup> This five-year period may be extended an additional

<sup>4</sup>To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization’s exempt purposes. Sec. 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under section 512 over the amount of unrelated business income tax imposed by section 511. Sec. 509(a)(2)(B).

<sup>5</sup>Sec. 509(a)(3). Organizations organized and operated exclusively for testing for public safety also are classified as public charities. Sec. 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under section 170.

<sup>6</sup>Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). Sec. 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (sec. 4941), are required to make a minimum amount of charitable distributions each year (sec. 4942), are limited in the extent to which they may control a business (sec. 4943), may not make speculative investments (sec. 4944), and may not make certain expenditures (sec. 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

<sup>7</sup>Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

<sup>8</sup>Sec. 4943(c)(6).

five years in limited circumstances.<sup>9</sup> The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.<sup>10</sup>

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

#### REASONS FOR CHANGE

In recent years, a new type of philanthropy has combined private sector entrepreneurship with charitable giving, such as through the donation of a private company's after-tax profits to charity. The Committee believes it is appropriate to encourage this form of philanthropy by eliminating certain legal impediments to its use, while also ensuring that private individuals cannot improperly benefit from charitable dollars. The Committee therefore believes it is appropriate to create an exception to the present-law private foundation excess business holdings rules for certain philanthropic business holdings. By so doing, the law will permit private philanthropists to bequeath an entire business to a private foundation, provided that the after-tax profits of the business will be paid to the foundation and certain other requirements are satisfied, while also ensuring that the donor's heirs cannot improperly benefit from the arrangement.

#### EXPLANATION OF PROVISION

The provision creates an exception to the excess business holdings rules for certain philanthropic business holdings. Specifically, the tax on excess business holdings does not apply with respect to the holdings of a private foundation in any business enterprise that, for the taxable year, satisfies: (1) the exclusive ownership requirements; (2) the "all profits to charity" requirement; and (3) the independent operation requirements.

The exclusive ownership requirements are satisfied if: (1) all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year; and (2) all the private foundation's ownership interests in the business enterprise were acquired under the terms of a will or trust upon the death of the testator or settlor, as the case may be.

The "all profits to charity" requirement is satisfied if the business enterprise, not later than 120 days after the close of the taxable year, distributes an amount equal to its net operating income for such taxable year to the private foundation. For this purpose, the net operating income of any business enterprise for any taxable year is an amount equal to the gross income of the business enterprise for the taxable year, reduced by the sum of: (1) the deductions allowed by chapter 1 of the Code for the taxable year that are directly connected with the production of the income; (2) the tax imposed by chapter 1 on the business enterprise for the taxable year;

<sup>9</sup>Sec. 4943(c)(7).

<sup>10</sup>Sec. 4943(d)(3).

and (3) an amount for a reasonable reserve for working capital and other business needs of the business enterprise.

The independent operation requirements are met if, at all times during the taxable year, the following three requirements are satisfied. First, no substantial contributor to the private foundation, or family member of such a contributor, is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of the foregoing). Second, at least a majority of the board of directors of the private foundation are individuals other than individuals who are either (1) directors or officers of the business enterprise or (2) members of the family of a substantial contributor to the private foundation. Third, there is no loan outstanding from the business enterprise to a substantial contributor to the private foundation or a family member of such contributor. For purposes of the independent operation requirements, “substantial contributor” has the meaning given to the term under section 4958(c)(3)(C), and family members are determined under section 4958(f)(4). The provision does not apply to the following organizations: (1) donor advised funds or supporting organizations that are subject to the excess business holdings rules by reason of section 4943(e) or (f); (2) any trust described in section 4947(a)(1) (relating to charitable trusts); or (3) any trust described in section 4947(a)(2) (relating to split-interest trusts).

#### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2014.

### III. BUDGET EFFECTS OF THE BILL

#### A. COMMITTEE ESTIMATES

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate and section 308(a)(1) of the Congressional Budget and Impoundment Control Act of 1974, as amended (the “Budget Act”), the following statement is made concerning the estimated budget effects of the revenue provisions of the “Philanthropic Enterprise Act of 2015” as reported.

The provisions are estimated to have a negligible effect on Federal fiscal year budget receipts for the period 2015–2025.

#### B. BUDGET AUTHORITY AND TAX EXPENDITURES

##### *Budget authority*

In compliance with section 308(a)(1) of the Budget Act, the Committee states that no provisions of the bill as reported involve new or increased budget authority.

##### *Tax expenditures*

In compliance with section 308(a)(1) of the Budget Act, the Committee states that no provisions of the bill as reported affect the levels of tax expenditures.

### C. CONSULTATION WITH CONGRESSIONAL BUDGET OFFICE

In accordance with section 402 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the bill. The letter from the Congressional Budget Office will be provided separately.

### IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the Committee states that, with a majority present, the “Philanthropic Enterprise Act of 2015,” was ordered favorably reported by voice vote on February 11, 2015.

### V. REGULATORY IMPACT AND OTHER MATTERS

#### A. REGULATORY IMPACT

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

#### *Impact on individuals and businesses, personal privacy and paperwork*

The bill provides an exception to the private foundation excess business holdings rules for certain philanthropic business holdings. The provisions of the bill are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

The provisions of the bill do not impact personal privacy.

#### B. UNFUNDED MANDATES STATEMENT

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (Pub. L. No. 104–4).

The Committee has determined that the tax provisions of the reported bill do not contain Federal private sector mandates or Federal intergovernmental mandates on State, local, or tribal governments within the meaning of Public Law 104–4, the Unfunded Mandates Reform Act of 1995. The costs required to comply with each Federal private sector mandate generally are no greater than the aggregate estimated budget effects of the provision.

#### C. TAX COMPLEXITY ANALYSIS

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (“IRS Reform Act”) requires the staff of the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Treasury Department) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code and has widespread applicability to individuals or small businesses. The staff of the Joint Committee on Taxation has determined that there are no provi-

sions that are of widespread applicability to individuals or small businesses.

**VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED**

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).

