Private Foundations: A Practical Guide to Key Issues, Choices, and Risks

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Excise Taxes/Prohibited Transactions

- Foundations are subject to prohibited transaction rules
- Violation of these rules result in excise taxes, and can arise from
  - Self Dealing (4941)
  - Failure to meet Minimum Distribution Requirements (4942)
  - Excess Business Holdings (4943)
  - Jeopardizing Investments (4944)
  - Taxable Expenditures (4945)

Tax on Net Investment Income – IRC §4940

- Private non-operating foundations
  - Tax is 2% of *Net Investment Income for taxable year*
  - Rate *reduced to 1%* in certain circumstances
- Cannot be avoided – not a penalty for engaging in an "prohibited transaction"

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Self-Dealing – IRC §4941

- *IRC 4941* imposes excise taxes with respect to any direct or indirect act of self-dealing between a private foundation and a disqualified person.
- Applies to the self-dealer and, in certain cases, the foundation managers.
- The rule and exceptions should be analyzed.

Self-Dealing Transactions

Self-dealing transactions described under *IRC 4941(d)* are:

- The sale, exchange, or leasing of property;
- The lending of money or other extension of credit;
- The furnishing of goods, services, or facilities;
- The payment of compensation or expenses by the foundation to a disqualified person;
- The transfer or use of the foundation's income or assets by or for the benefit of a disqualified person; and
- Certain payments to government officials

Note: Special rules and exceptions apply.

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Self-Dealing (Disqualified Persons)

- **Foundation Managers** (officers, directors, trustees)
- **Substantial contributors** (greater than 2% of total contributions since inception and more than $5000)
- **20% Owners** (owner of 20%+ control of organization that is a substantial contributor)
- **Family Member** of (1), (2) or (3) (spouses, ancestors, children, grandchildren, great grandchildren)
- **35% owned entities** (organizations more than 35% controlled by any of the above)

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Exceptions to Self-Dealing

- General Rule –
  - Free TO the Foundation is OK
- Loans or other extensions of credit by a disqualified person to a private foundation without interest or other charge;
- Pledges of money or property to a private foundation by a disqualified person;
- Performance of certain general banking services (the maintenance of checking and savings accounts and safe deposit boxes (but not certificates of deposit)) for a private foundation by a bank or trust company which is a disqualified person.

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Exceptions to Self-Dealing

- Certain transactions during the administration of an estate or revocable trust
- Furnishing goods, etc. in a reasonable amount to a foundation manager in consideration for services performed in the capacity of foundation manager
- Furnishing of goods, etc., to a private foundation by a disqualified person without charge
  - The furnishing of goods is considered without charge even though the foundation pays for transportation, insurance, or maintenance costs it incurs in obtaining or using the property, so long as the payment is not made directly or indirectly to the disqualified person.

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Exceptions to Self-Dealing

- Furnishing of goods, services, or facilities by a private foundation to a disqualified person is not an act of self-dealing if the furnishing is made on a basis no more favorable than that on which is made available to the general public
  - In order for the exception to apply, the furnishing of goods, services, or facilities by the foundation must be functionally related to its exempt purposes

Exceptions to Self-Dealing

- Payment of compensation by a foundation to or reimbursement of expenses of a disqualified party for the performance of **personal** services **reasonable and necessary** to carrying out the **exempt purposes** of the foundation, if the payment is **not excessive**.

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Self-Dealing Excise Tax - §4941

- 1st Tier:
  - Disqualified Person: 10% of amount involved for each year uncorrected (paid by self-dealer)
  - Foundation Manager: 5% if willingly participated, knowing prohibited (max $20,000)
- 2nd Tier (Applies where not timely corrected):
  - Disqualified Person: additional 200%
  - Foundation Manager: additional 50% (max $20,000)
- Second tier taxes may be abated under §4961; **initial §4941 taxes may not be abated.**
- **Reasonable cause must be established.**

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Taxes on Failure to Distribute Income – IRC §4942

- Minimum distributions required
- Tax imposed on excess of *distributable amount* over *qualifying distributions*
- Tax imposed on PF for failure to satisfy distribution requirement
- Exceptions – tax does not apply to
  - Operating foundations
  - Insufficient distributions due to incorrect valuation of assets

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Minimum Distribution Requirements

- § 4942(d) – "Distributable Amount":
- Private Foundation must generally distribute at least 5% of its Asset Base on an annual basis in qualifying distributions
  - Asset Base includes those assets not used in furtherance of the foundation's exempt purposes, such as the foundation's office building
  - Generally includes cash, stocks, bonds and other investment assets
  - Less §4940 taxes
- Must distribute by end of succeeding tax year

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Taxes on Failure to Distribute Income – IRC §4942

- §4942(g)– *"Qualifying Distributions"*
- Any amount paid to accomplish exempt purposes (including reasonable and necessary administrative expenses) or acquire assets used or held for use for exempt purposes (as per §170(c)(2)(B))
- Exceptions
  - Distributions to organizations controlled by PF's disqualified persons (unless pass-through foundation with documentation of pass-thru - §4942(g)(3))
  - Distributions to other PF's (other than pass-throughs or operating foundations)

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Qualifying Distribution Analysis-IRC §4942(g)

Grantee Status:	QD?
Non-controlled 509(a)(1), (a)(2)	Yes
Controlled 509(a)(1), (a)(2)	Only if out of corpus (“OOC”) rules followed
509(a)(3), Type I,I, FI III	Yes unless grantee or its supported orgs are controlled by PFs DPs
509(a)(3), NFI III	No
GE’s	Yes
PNoF	Only if OOC rules followed
PoF	Yes unless controlled and then OOC rule
Non-(c)(3)’s	Yes if for 170 (c)(2)(B) purposes <u>unless</u> grantee controlled by PF or its DPs (no OOC rules)
International	Yes for 170(c)(2)(B)
Individuals for Travel, Study	Yes for 170(c)(2)(B)
Individuals for other Charitable Purposes	Yes
Individuals Achievement	Yes
PRI’s	Yes

Failure to Distribute Income - IRC §4942

- 1st tier:
  - Foundation: 30% on difference of what should have been distributed and what was distributed (i.e. Undistributed Amount)
- 2nd tier:
  - Foundation: additional 100% of Undistributed Amount if penalty assessed and correction not made

Excess Business Holdings – IRC §4943

- Foundations are limited in business ownership, and may only own
  - 20% of voting stock in a corporation, reduced by the percentage owned by all Disqualified Persons
  - 35% of voting interest (reduced by what Disqualified Person owns) if control is not in Disqualified Person
  - De minimis 2% voting stock or value

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Excess Business Holdings Rules – IRC §4943

- Exceptions:
  - A functionally related business i.e. (not UBI but part of an activity related to the exempt purposes of the organization)
  - A trade or business at least 95% of the gross income of which is derived from passive sources

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Excess Business Holdings – IRC §4943

- 5 years to dispose of Excess Business Holdings
- Additional 5 years if an unusually large gift or bequest
- May not dispose of interest to a Disqualified Person

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Excess Business Holdings – IRC §4943

- 1st tier:
  - Foundation: 10% of the Excess Business Holding
- 2nd tier:
  - Foundation: additional 200% of the Excess Business Holding if not timely corrected

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Jeopardizing Investments – IRC § 4944

Internal Revenue Code = Prudent Person Standard

- "A private foundation must not make investments which would jeopardize the carrying out of its exempt purposes" I.R.C. § 4944
- An investment shall be considered to jeopardize the carrying out of the exempt purposes of a Foundation if it is determined that:
  - The Foundation Managers, in making such investment:
    - Have failed to exercise ordinary business care and prudence
    - Under the facts and circumstances prevailing at the time of making the investment
    - In providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes

Jeopardizing Investments

- Exercising ordinary business care and prudence - Take into account:
  - the expected return (including both income from and appreciation of capital)
  - risks of rising and falling price levels
  - the need for diversification within the investment portfolio
- Jeopardizing investments are determined on an investment by investment basis, in each case taking into account the foundation's <u>investment portfolio as a whole</u>

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Jeopardizing Investments – Hedge Funds

- Debt and leveraging of assets, generally through a limited partnership, are inherent to hedge fund investments and transactions
- The debt of a limited partnership is attributed to the partners for purposes of UBTI (Section 512(c)(1) and Section 514)
- Offshore blocker corporations that feed their income to the parent exempt organization were the solution in times past – the partnership income (and debt) is directed through a foreign corporation, owned (in part or total) by the exempt organization. That procedure is under government review

Exception to the Jeopardizing Investments Prohibition

- Exception For Program-Related Investments. – For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

Treasury Regulation 53.4944-3

- The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);
- No significant purpose of the investment is the production of income or the appreciation of property; and
- No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes].

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Jeopardizing Investments – IRC §4944

- 1st tier:
  - Foundation: 10% of improperly invested assets
  - Foundation manager: 10% of improperly invested assets
- 2nd tier:
  - Foundation: additional 25%
  - Foundation manager: additional 5%

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Taxable Expenditures - §4945

- Amounts expended for lobbying; or to influence the outcome of any specific public election;
- Amounts paid as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved in advance by the IRS;
- Amounts Paid as a grant to an organization unless such organization is:
  - A 509(a)(1) or 509(a)(2) organization
  - A 509(a)(3) organization other than that described in clause (i) or (ii) of sec. 4942(g)(4)(A)
  - An exempt operating foundation
  - Or, the foundation exercises expenditure responsibility
- Amounts expended for any non-charitable purpose.

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Grants to Foreign Charities

- Foreign Grantees must either have:
  - A § 501(c)(3) public charity status determination letter from the IRS, or
  - The Grantor Foundation must make a good faith determination that the foreign organization would likely qualify as a public charity (501(c)(3) Equivalent).
  - Rev. Proc. 92-94, 1992-2 C.B. 507, describes the requirements for making such a good faith determination.
- Otherwise, must exercise expenditure responsibility

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Expenditure Responsibility

- Requires foundation to make all reasonable efforts and establish adequate procedures:
  - To see that the grant is spent only for the purpose for which it is made
  - To obtain full and complete reports from the grantee organization on how the funds are spent, and
  - To make full and detailed reports on the expenditures to the IRS

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Expenditure Responsibility

- Pre-grant inquiry
  - Investigating the identity, prior history and experience of the grantee organization and its managers to determine if the grantee is capable of accomplishing the grant purpose
- Written grant commitment, signed by an appropriate officer of the grantee, containing the grantee's agreement to:
  - Repay any portion of grant not used for the purposes of grant,
  - Submit full and complete annual reports on expenditures and progress made in accomplishing purposes of grant,
  - Maintain records of receipts and expenditures and make its books and records available to the grantor, and
  - Not use any grant funds to carry on propaganda, or otherwise attempt to influence legislation; to influence the outcome of any specific public election or to carry on directly or indirectly any voter registration drive; to make any grant which does not comply with 4945(d)(3) or (4) or to undertake any activity for any purpose other than one specified in section 170(c)(2)(B).
- Receive and review grantee reports
- Investigate any diversions of funds
- Report to Internal Revenue Service (annually)

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Taxable Expenditures

- 1st tier:
  - Foundation: 20% on each Taxable Expenditure
  - Foundation manager: 5% on each Taxable Expenditure (capped at $10,000/exp.)
- 2nd tier:
  - Foundation: additional 100% of the amount expended
  - Foundation manager: additional 50% (capped at $20,000/exp.)

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Taxable Expenditure Rules

Grantee Status:	TE?
Non-controlled 509(a)(1), (a)(2)	No unless earmarked for improper purposes
Controlled 509(a)(1), (a)(2)	No unless earmarked for improper purposes
509(a)(3), Type I,I, FI III	No unless controlled by PFs DPs and then ER required
509(a)(3), NFI III	Yes unless ER exercised
GE's	No unless earmarked for improper purposes
PNoF	Yes unless ER exercised
PoF	Yes unless ER exercised
Non-(c)(3)'s	Yes unless ER exercised and segregated account used
International	Yes unless ER/ED followed
Individuals for Travel, Study	Yes unless pre-approved plan
Individuals for other Charitable Purposes	No
Individuals Achievement	No
PRI's	No but ER required if not to PC

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique.
The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.
Non-lawyers are advised to consult an attorney before undertaking any issues addressed herein.