



## Good Intentions Can Lead to Unintended Consequences

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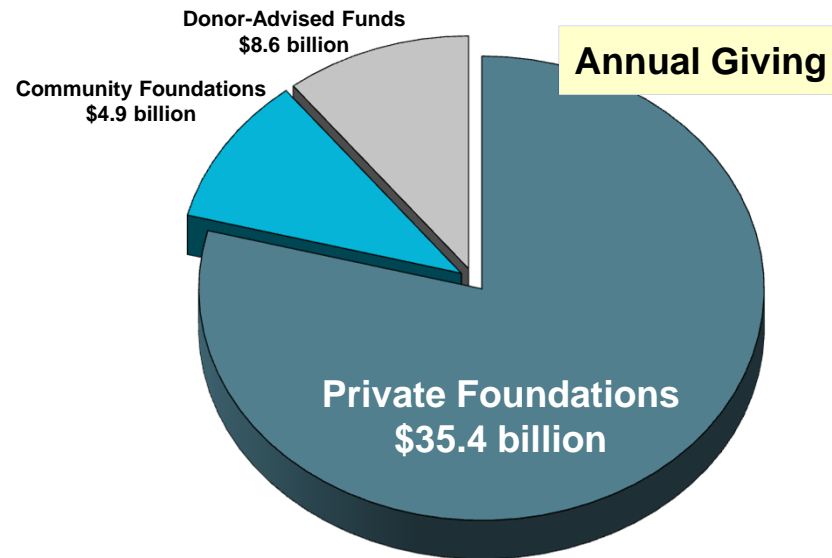
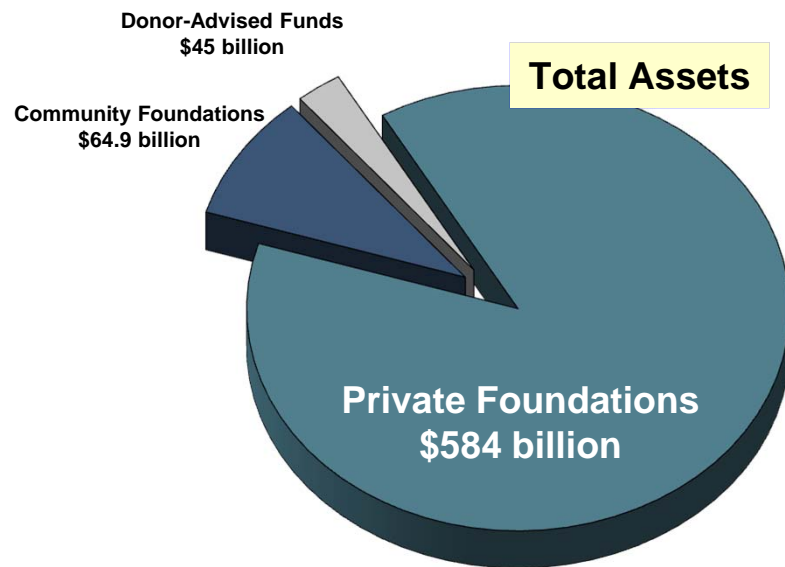
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**Foundation** / **Source**

# Establishing a Philanthropic Legacy

When it comes to both total assets and annual grantmaking, the private foundation dominates the philanthropic landscape.





Private Foundation  
Compliance Fundamentals

## Exemption Under Section 501(c)(3)

- PFs are nonprofit organizations that are exempt from federal income tax under Section 501(c)(3)
- PFs are organized exclusively for charitable, educational, religious, scientific, literary, and other named purposes under Section 501(c)(3)
- In order for donations to be tax deductible, the PF must be officially recognized by the IRS as a Section 501(c)(3) charitable organization
- PFs apply for recognition of exempt status by filing IRS Form 1023
- If IRS Form 1023 is filed within 27 months of formation, recognition of exemption is retroactive to date of formation

# Tax Deductibility

- Up to 30% of adjusted gross income (AGI) for donations of cash
- Up to 20% of AGI for non-cash donations
- Fair market value (FMV) deduction for contribution of “qualified appreciated stock,” which is generally:
  - Publicly traded stock having market quotations readily available on an established securities market
  - Held for over 12 months (long term capital gain property)
  - No more than 10% (in value) of all of the outstanding stock of the issuing corporation
- The deduction for contribution of other non-cash property is limited to the lesser of basis and FMV

# Background of Private Foundation Tax Law

- The PF is a powerful vehicle for implementing philanthropic activities
- There is a series of special tax rules in the Internal Revenue Code dedicated to PFs
- Congress enacted provisions to prevent the operation of PFs for the benefit of their creators
- Creators and other insiders are known as “Disqualified Persons”
- Disqualified persons and PFs can be subject to tax penalties when conducting certain transactions

## Headlines in the News

- “Legislation Eyed to Fight Abuses at Foundations”
- “AG Charities Chief to Review Salaries at 2 Foundations”
- “Philanthropist’s Millions Enrich Family Retainers”
- “Foundation Veers into Business”
- “Massachusetts and 2 other States Probe Foundations”
- “Making Philanthropy Accountable: New York’s Top Regulator Pushes for Far Reaching Changes”

# Typical Areas of Scrutiny

- Self-dealing issues
- Trustee and employee compensation
- Travel-related expenses
- Financial transactions with insiders
- Grants to non-public charities, especially cross-border grants
- Fundraising
- Grants to individuals



# Excise Tax on Net Investment Income

- A PF must annually pay a 2% (sometimes 1%) excise tax on specific types of income earned on its investments, including:
  - Interest
  - Dividends
  - Rents
  - Royalties
  - Income from sources similar to the above types of income
  - Capital gains
- Investment-related expenses may be deducted from income
- Excise taxes are calculated and paid annually, but quarterly estimated tax payments, if significant, may be required

# Self-Dealing

- Subject to narrow exceptions, the self-dealing rules prevent a PF and its disqualified persons (insiders) from entering into most financial transactions
- It is immaterial whether the transaction benefits the PF
- The self-dealer (not the PF) is personally responsible for paying a 10% penalty on the “amount involved” and the PF may not indemnify the self-dealer
- The IRS lacks the authority to forgive (abate) a self-dealing penalty, even if the violation was inadvertent or there was reasonable cause

## Key Self-Dealing Activities

- Sale, exchange, or lease of property between the PF and a disqualified person
- Loan of money or other extension of credit between a disqualified person and the PF
- Furnishing of goods, services, or facilities by a disqualified person to the PF and vice versa
- Use of or benefit from income or assets belonging to the PF, such as retaining artwork on private premises

## Key Exceptions to Self-Dealing

- Reasonable compensation for trustees, directors, officers, and other disqualified persons who render personal services to the PF
- Loan of funds *to* the PF at no interest for a charitable purpose
- Reimbursement of reasonable expenses incurred in carrying out PF business
- Rent-free office space provided to the PF by disqualified persons

*No exception for sales or exchanges between the PF and disqualified persons, even if the deal's terms favor the PF*

## Who Is a Disqualified Person?

- A PF's trustees, directors, officers (foundation managers), substantial contributors, and certain family members of such individuals
- Certain entities in which certain disqualified persons, collectively, have a greater than 35% ownership or beneficial interest
- An owner of more than a 20% interest in an entity that is a substantial contributor to the PF
- Government officials (only for purposes of the self-dealing rules)

# Who Is a Foundation Manager?

- A “Foundation Manager” includes a private foundation’s:
  - Officers
  - Directors
  - Trustees
  - Individuals having similar powers or responsibilities
- Advisors engaged as independent contractors with no direct legal authority are not managers

# Who Is a Substantial Contributor?

- A substantial contributor is one who:
  - Is the creator of a foundation that is formed as a trust;  
or
  - Has given, as of the end of any given PF tax year, an aggregate of more than \$5,000 and more than 2% of the total aggregate contributions the organization has received since the PF's inception
- Once classified as a substantial contributor, the classification generally lasts forever

# Who Is a Family Member?

The term “family member” includes:

- Spouse
- Ancestors
- Children, grandchildren, and great-grandchildren
- Spouses of children, grandchildren, and great-grandchildren
- Legally adopted children

Does not include :

- Brothers, sisters, cousins, aunts, uncles, nieces, nephews, and any more distant relatives



## Certain 20%+ Owners

- An owner of more than 20% of a substantial contributor entity is a disqualified person
- Ownership is measured differently for different entities:
  - Corporation: by combined voting power
  - Partnership: by profits interest
  - Unincorporated business: by distributive share of profits
  - Trust: by beneficial interest



*Indirect ownership a possibility*

## 35%+ Entities

- Corporation

- A corporation is a disqualified person if > 35% of the total combined voting power is owned by certain disqualified persons

- Partnership

- A partnership is a disqualified person if > 35% of the profits interest is owned by certain disqualified persons

- Trusts & Estates

- A trust or estate is a disqualified person if > 35% of the beneficial interest is held by certain disqualified persons



*Indirect ownership a possibility*

# Stay Alert for Indirect Ownership



- For purposes of applying the > 20% and >35% ownership rules:
  - An individual is considered to own the stock owned by his or her family members
  - Stock, a partnership interest, or a beneficial interest in a trust that is owned, directly or indirectly, by or for a corporation, partnership, trust, or estate *is considered as being owned proportionately* by or for its shareholders, partners, or beneficiaries

## Example #1 – Indirect Ownership

- XYZ Co. is a substantial contributor to Foundation
- John owns 15% of XYZ Co.
- Michelle, John's spouse, owns 10% of XYZ Co.

John would like to sell his ranch to Foundation. May he do so?

John is considered to own 25% of XYZ Co. (15% + 10%)

Since John owns more than 20% of XYZ Co., he is a disqualified person

*The proposed sale would result in a self-dealing violation*

## Example #2 – Indirect Ownership

- Marty and Cindy are disqualified persons because they are directors of Foundation
- Marty and Cindy collectively own 80% of Parent Co.
- Parent Co. owns 90% of Sub Co.

Foundation would like to lease office space from Sub Co.  
May it do so?

Collectively, Marty and Cindy are considered to own 72% of Sub Co. through Parent Co. (80% of 90% = 72%).  
Marty and Cindy indirectly own more than 35% of Sub Co., making it a disqualified person

*The proposed lease would result in a self-dealing violation*

# Annual Minimum Distribution Requirement

- Generally, PFs must distribute for charitable purposes at least 5% of the average net investment assets from the preceding year
- These distributions may include grants to other charities as well as certain administrative expenses, such as legal or accounting fees
- Grants and qualifying expenses made in excess of the 5% may be applied to satisfy future years' requirements
- If the minimum distribution requirement is missed, a 30% penalty is assessed on the amount of the underdistribution each year until the shortfall is made up

# Excess Business Holdings

- Intended to limit the stake a PF can have in a going business concern
- Generally, a PF and its disqualified persons, collectively, are limited to a 20% ownership stake in a business enterprise (sometimes 35%)
- De minimis exception available if a PF owns no more than 2% of the voting stock and value of all classes of outstanding stock
- Exception allows for unlimited ownership stake in a passive investment vehicle (as opposed to a business enterprise)
- 5-year grace period for ownership interests donated to the PF
- A 10% penalty can be assessed on the value of the PF's excess holdings each year until corrected

# Jeopardizing Investments

- Investments that show a lack of reasonable business care and prudence in providing for the PF's long- and short-term financial needs
- A determination must be made on an investment-by-investment basis taking into account the PF's portfolio as a whole
- The foundation managers may take into account expected returns, risks of rising and falling prices, and the need for diversification within the investment portfolio
- Whether an investment jeopardizes the PF's exempt purposes is determined at the time the investment is made, not in hindsight
- A 10% penalty is assessed on the amount invested in a jeopardizing manner



# Taxable Expenditures

- PF funds must be spent only for charitable purposes
- Electioneering or engaging in any effort to intervene in the outcome of an election is prohibited
- Making payments for lobbying or attempting to influence the passage of legislation is prohibited
- Certain grants to individuals and grants to non-public charities are limited
- A 20% penalty is assessed on the amount of each taxable expenditure

# Taxable Expenditures

## Grants to Individuals

- A private foundation can grant money to individuals in specific circumstances, including:
  - Grants in aid
  - Scholarship grants
  - Prizes, awards, and fellowships
- Special rules apply in each case

# Taxable Expenditures

## Grants to Organizations That Are Not Public Charities

- Under the right circumstances, a private foundation can grant funds to support programs of:
  - Another private foundation
  - Foreign organization
  - A for-profit entity (conceivably), so long as the payment serves its charitable purposes
- Expenditure responsibility agreements are required
  - Possible exception: If the grantee is a foreign organization and the PF has determined that the grantee is the *equivalent* of a US public charity

# Expenditure Responsibility Components

- **Pre-grant inquiry** – review of organization’s mission and purpose, financial position, plan of action, charitable purpose of project, and budget
- **Written agreement** – signed and dated by the PF and signed by the grantee, outlining the charitable purposes of the grant and all other grant terms
- **Separate Account** – Unless grantee is another PF, grantee must establish a separate “account” for the funds granted (this can be a separate bookkeeping/ account in the general ledger)
- **Regular reports** – must be provided on the expenditure of funds and the progress made in fulfilling the charitable purpose of the grant. Reports are due at end of the grantee’s fiscal year, every year, until all funds are expended, plus a final report
- **Report Grant on Form 990-PF** – a special schedule is attached to the PF’s tax return each year in which: (i) a grant has been made, (ii) the grant funds have not been fully spent by the grantee, and (iii) a report has been received

# Direct Charitable Activity

A PF can conduct a *direct* charitable activity (DCA), such as:

- Creating a film on nutrition and school lunch programs
- Conducting a survey of healthcare entities in its area
- Operating a soup kitchen for the poor
- Conducting other projects with a charitable purpose serving the general public

# Direct Charitable Activity

Why conduct a DCA at all?

- Special expertise or vision of foundation donors and managers
- Desire of foundation donors to get down “in the trenches”
- Capacity of foundation to promote collaboration among multiple funders or grantees
- Desire to inform public policy or advance public knowledge of a charitable area

# Direct Charitable Activity Examples

## Issues for all DCAs:

- Is the planned DCA a legitimate charitable activity?
- Are there special compliance issues to consider?
- Do foundation managers have the expertise to carry out the project?
- How will DCA expenses be accounted for so as to be accurately reported on 990-PF?
- Watch for possible self-dealing issues when disqualified persons are involved in procuring resources used in DCA

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Private Foundation  
Case Studies



## Donating Mortgaged Real Estate

The founder of a PF has a \$5 million ranch that he is unable to sell. He decides to donate the ranch to his PF if the foundation assumes the small remaining amount of the original, 30-year-old mortgage. Is the founder's generous gift problematic?

Would the result be any different if the PF took the ranch subject to the mortgage?

What if the mortgage was placed on the ranch just five years ago, by the founder's sister, and the PF agrees to take the property subject to that mortgage?

What if the founder and his family plan to continue to have occasional access to the ranch while it is owned by the PF?

## Honoring a Pledge

A husband and wife are both graduates of a large, eastern university. At their 20th reunion, the couple was asked to donate to a capital campaign for the construction of a new science building for their alma mater. The husband and wife agreed to be lead donors and signed a binding pledge agreement with the school.

Based on the pledge agreement, the school obtained interim construction financing, announced the gift and the naming of the building, and began construction.

After all of this occurred, the husband and wife decided to establish their own PF and have the PF satisfy the balance of their pledge.

Is their decision to have the PF satisfy the pledge problematic?

## Recognition for a Major Gift

A PF agreed to make a \$2 million grant to a medical school for the construction of a new research building.

The founder of the PF asked to have the building named after himself and have a plaque with his name put on an outside wing.

Would honoring the founder's request result in a self-dealing violation?

# Compensating Disqualified Persons

A family PF was governed by a husband and wife and an adult son, who is a college graduate but unemployed. The PF had \$5 million in assets and a payout requirement of \$250,000 per year.

The son would like to be the executive director of the PF and be paid an annual salary of \$60,000. He anticipated that it would take him two to three hours per week to discharge the responsibilities of this position.

Would paying the son the desired salary be problematic?

# Scholarship Programs

A PF president decided to provide scholarship funds from his PF to deserving students. He and his board reviewed the applications and made their final selections based on objective criteria.

As the board did not wish to apply for advance IRS approval for the PF's scholarship program, they made sure that all scholarship checks were mailed directly to the educational institutions rather than to the students themselves.

Is this approach problematic?

## Emergency Assistance to Individuals

The president of a PF read an article in his local newspaper about a middle-class family whose house was destroyed by a fire. The article noted that the family was temporarily unable to provide for its own basic needs (no cash, no credit cards, only the clothing on their backs).

The president discussed the situation with his PF's board. The board decided to donate \$5,000 to help the family get back on its feet. That afternoon, the PF president personally delivered a check to the needy family instructing them to "use these funds however you wish."

Is the PF's donation directly to the family permissible?

# Earmarking a Grant to a Public Charity

A PF makes a grant to a US public charity for the specific purpose of supporting a named foreign organization.

Is this a valid way to avoid exercising expenditure responsibility?

What if the grant instead was unrestricted, with a non-binding recommendation that the funds be re-granted to the foreign organization?

What if the grant was required to be used for educational purposes and, subsequently, the charity decided to grant the funds to a foreign organization organized for educational purposes?

# Grants to Foreign Organizations

A PF makes a grant to a foreign organization by exercising expenditure responsibility.

Can the grantee use the grant funds to make grants to other foreign organizations?

Can the grantee use the funds to make scholarship grants to individuals?

What if the PF had made an equivalence determination?



## Grants to Individuals

A PF wants to commission an artist to create a sculpture. The PF pays the artist the going rate for creating such a sculpture and it is agreed that the PF will own the sculpture.

Does this payment to the individual require advance approval as a grant to an individual under Section 4945(g)(3)?

What if the artist is requesting funding to enable him or her to create the sculpture, and the artist is allowed to keep the sculpture when it's finished?

## Excess Business Holdings

The PF's president contributes to his PF 20% of the voting stock of ABC Corp., a privately held corporation that is a holding company for other investments. Even after the contribution, the president personally still owns 10% of the stock of ABC Corp.

Will the donation result in a violation of the excess business holdings rules for the PF?

What if ABC Corp. were an active business (rather than merely a passive investment vehicle), generating income from the sale of goods or services?

If ABC Corp. were an active business, what would be the result if the PF had purchased the stock (assuming that the seller was not a disqualified person)?

# Foundation Source

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