PRIVATE FOUNDATIONS:

WHAT THE TAX DEPARTMENT

SHOULD KNOW

By

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WHAT THE TAX DEPARTMENT SHOULD KNOW ABOUT PRIVATE FOUNDATIONS

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I. Overview

A. What is a private foundation?

1. A private foundation is a trust or nonprofit corporation that is exempt from federal income tax under Section 501(c)(3)[2] and is not classified as a public charity. Section 501(c)(3) exempts from federal income tax organizations that are organized and operated for charitable, educational, scientific and similar purposes. All organizations exempt under Section 501(c)(3) are classified as private foundations unless they meet the definition of one of the four types of public charities described in Section 509(a)(1) through (a)(4). Those provisions define public charities as:

a) *Section 509(a)(1):* "Traditional Public Charities": organizations described in section 170(b)(1)(A), which includes public organizations such as churches, hospitals, schools, and governmental units.

b) *Section 509(a)(2):* "Publicly Supported Organizations": a public organization that can demonstrate that more than one-third of its support in each taxable year comes from the general public as opposed to founders, managers, and substantial contributors and that no more than one-third of support comes from the sum of gross investment income and unrelated business taxable income.

c) *Section 509(a)(3):* "Supporting Organizations": an organization that is organized and operated exclusively for the benefit of one or more organizations described in 509(a)(1) or 509(a)(2).

d) *Section 509(a)(4):* "Public Safety Organizations": an organization organized and operated exclusively to test for public safety.

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[1] The author thanks Gregory N. Kidder, Esq., an associate at Steptoe & Johnson, for his assistance.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

2. Private foundations are typically privately funded and privately controlled by one or a small number of persons such as a family or a corporation. Private foundations also typically derive their revenue from investment income and make grants to other charitable organizations rather than operate their own programs.[3] This outline is limited to private nonoperating foundations.

B. Regulation of Private Foundations: The Excise Tax Regime

Because private foundations are privately funded and privately controlled, they are subject to a stringent set of regulations to insure that their charitable purposes are fulfilled. The regulatory structure consists of excise taxes that are imposed on specified persons with substantial influence over the organization ("disqualified persons") and foundation managers if the foundation engages in prohibited activities or fails to meet certain requirements. The law imposes excise taxes on disqualified persons and foundation managers for acts of self-dealing, failure to meet minimum distribution requirements, excess business holdings, jeopardizing investments, and engaging in lobbying and political activities. In addition, there is a 2% tax on investment income and a tax on termination. Each of these provisions is discussed in detail below.

II. Role of Private Foundations in Corporate Philanthropy

A. Value of Corporate Philanthropy

Studies have shown that corporate philanthropy programs that are viewed favorably by customers, employees, and shareholders contribute to business success. Corporate philanthropy is sometimes referred to as "enlightened self interest" to reflect that it has a public relations and advertising component, and is undertaken with the objective of improving the company's business results. Corporate charitable giving frequently supports the communities in which the corporations are located, employee programs, and educational programs related to the company's business.

B. The Use of Private Foundations

A private foundation is a legal entity with separate bylaws and governance structures from the sponsoring company. According to the Council on Foundations, there are nearly 2,000 corporate foundations in the United States holding some $9.5 billion in assets. Creating a private foundation has advantages and disadvantages compared to a charitable giving program conducted directly by a corporation.

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[3] While not as common as grant making foundations, a private foundation may directly conduct its own charitable programs. A private operating foundation is essentially a hybrid that is treated as a private foundation in some respects and as a public charity in others. A private operating foundation is subject to most of the rules controlling private foundations, but is also given some of the advantages of being a public charity. See Treas. Reg. Section 53.4942(b)-1(a)(1).

C. Advantages of Private Foundations

1. The existence of a separate legal entity for charitable giving encourages and facilitates the establishment of tactical and strategic goals for charitable giving.

2. A private foundation centralizes accountability for the corporation's charitable giving program. In the absence of a foundation, charitable giving is often handled on a decentralized and ad hoc basis by different departments.

3. A corporate foundation is usually named after its sponsoring corporation and thus provides greater public recognition for the foundation's charitable activities than the corporation would receive from direct charitable gifts to various charities.

4. An independent entity can buffer management from external and internal requests and pressures for support of charities of friends, colleagues, and employees.

5. A foundation enables a corporation to maintain a relatively constant level of charitable giving over the years by building foundation reserves in highly profitable years and spending foundation reserves in less profitable years.

6. Private foundations can make grants to noncharitable recipients and foreign charities while corporations can make tax deductible charitable contributions only to Section 501(c)(3) organizations.

D. Disadvantages

1. Time and cost of monitoring compliance with Treasury regulations.

2. Risk of liability for excise taxes for failure to comply with applicable rules.

3. Loss of flexibility to integrate giving with corporate activities because of restrictions on self-dealing as well as any restrictions placed in the foundation's articles of incorporation, bylaws, or policies.

E. Direct Charitable Giving Combined with a Private Foundation

Some corporations use both a corporate foundation and direct charitable giving for their corporate philanthropy.

III. Starting and Funding a Private Foundation

A. **Formation**. A private foundation may be formed as a trust or a nonprofit corporation. For company foundations, a corporation is usually preferable.

1. **State Law Aspects**

   a) *Trust vs. Corporation.* The formation of a trust or corporation is governed by state law. In general, a corporation has more formal operating requirements (e.g., regular board meetings, minutes, filing of reports) but it is easier to amend corporate Articles of Incorporation and Bylaws, thus providing more flexibility to adapt to change. Charitable trusts usually have few operational requirements but are more difficult to amend, often requiring court approval and notice to the attorney general. Many states permit corporations to indemnify corporate officers or directors but do not have similar provisions for trustees of a trust. See, e.g., RESTATEMENT (SECOND) OF TRUSTS §367 (1959) (modification of a charitable trust), D.C. CODE ANN. §29-301 (2002) (provisions regarding nonprofit corporations).

   b) *Organizational Documents.* State law governs the requirements for forming a trust or corporation. For a trust, the only required document is usually the trust agreement. For a corporation, it is usually necessary to have Articles of Incorporation, which are filed with the Secretary of State and are a matter of public record, Bylaws, Organizational Minutes, and a Corporate Seal and minute book. See, e.g., RESTATEMENT (SECOND) OF TRUSTS §349 (1959) (creation of a charitable trust) D.C. CODE ANN. §29-301 (2002) (provisions regarding nonprofit corporations), D.C. CODE ANN. §21-801 (2002) (provision incorporating rules against self-dealing, excess business holdings etc. into the governing instrument of all charitable trusts governed by the laws of the District of Columbia).

2. **Federal Tax Aspects.** Tax-exempt corporations are permitted to make contributions to foreign charities but charitable trusts are not. Tax rates on trusts are generally higher than tax rates on corporations, a fact that is relevant only if the private foundation expects to have any unrelated trade or business income. The unrelated business income tax ("UBIT") is imposed on exempt organizations that engage in a trade or business that is regularly carried on and is not related to its exempt purpose. See sections 511-513. In addition, while investment income is generally not subject to UBIT, it is subject to UBIT to the extent that it is debt-financed. Thus, for example, a real estate investment that is subject to a mortgage would be subject to UBIT.

B. Recognition of Tax-Exempt Status

1. **Federal Income Taxes.** A new organization that wishes to be treated as tax-exempt under section 501(c)(3) must notify the Secretary on Form 1023, "Application for Recognition of Exemption," that it is applying for recognition of 501(c)(3) tax-exempt status. This Form asks questions about

the intended activities of the organization and its specific sources of support and funding. Careful attention should be paid to the language used in the application because such language will be the basis upon which the organization's tax-exempt status is recognized. If the organization later makes a material change in its activities, it must disclose the change on its Form 990.

2. **State Franchise and Income Taxes.** Some states require that an organization file an application with the state to be treated as tax-exempt while others treat any organization that qualifies for federal tax exemption under Section 501(c)(3) as exempt from income and franchise taxes under state law.

C. Federal Tax Treatment of Contributions to a Private Foundation

1. **Limitation on Charitable Deduction.** A corporation's deductible charitable contributions may not exceed 10% of pre-tax net income. Section 170(b)(2).

2. **Amount of Deduction**

    a) *General Rule*. The amount of the deduction for a charitable contribution of property is calculated based on the fair market value of the property. Fair market value is defined generally as, "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. section 1.170A-1(c)(2).

    b) *Ordinary Income Property*

        i) The amount of the deduction is reduced by the amount that would have been ordinary income to the donor had the donor sold the property for fair market value. Therefore corporate contributions of inventory are only deductible on a cost basis. Section 170(e)(1)(A).

        ii) Treasury regulation section 170A-1(c)(4) provides rules for when costs of inventory donated for charitable purposes are properly deducted as cost of goods sold or as charitable contributions. The regulation provides, "[a]ny costs and expenses which are treated as part of the cost of goods sold for the year of contribution, and any such costs and expenses which are properly deducted under section 162 or other section of the Code, are not to be treated under any section of the Code as resulting in any basis for the contributed property. Thus, for example, the contributed property has no basis for purposes of determining…the amount of gain that would have been recognized if such property had been sold by the donor at its fair market value at the time of its contribution." The amount of the deduction is not reduced by any cost or expenses properly deducted in years prior to the year of contribution.

c) *Capital Gain Property*

i) *General Rule*. The amount of the charitable deduction that would otherwise be determined must be reduced by the amount of gain that would have been short-term or long-term capital gain if the property contributed had been sold by the donor at its fair market value, determined at the time of contribution. Section 170(e)(1)(B).

ii) *Exception for Publicly Traded Stock.* When qualified appreciated stock is donated, the charitable deduction is based on the fair market value of the stock at the time of the gift. Qualified appreciated stock is stock that is capital gain property and for which, on the date of contribution, market quotations are readily available on an established securities market.

Qualified appreciated stock does not include any stock contributed by a donor to a private foundation to the extent that the amount in value of the stock contributed, including prior gifts of stock by the donor, exceeds 10% of all of the outstanding stock of the corporation. Section 170(e)(5).

3. Recordkeeping Requirements

Where money is contributed, the taxpayer is required to keep a receipt or some other reliable written evidence of the contribution. For contributions of property other than money the taxpayer must also have a receipt as well as a reliable written record of other information specified in Treasury regulation section 1.170A-13. Contributions of property worth more than $5000 are subject to additional recordkeeping requirements.

IV. Overview of Private Foundation Excise Tax Regime

A. Legislative History

The current rules governing private foundations were enacted as part of the Tax Reform Act of 1969. Congress had been concerned for many years that some people were using private foundations for private benefit rather than for the charitable purposes for which they were ostensibly formed. Congress had enacted various rules beginning in 1950, all of which had proved ineffective to stem the tide of abuse. In 1965, the Treasury Department submitted to Congress a report describing foundation abuses and recommending legislative changes. Congress' response was the enactment of a strict set of rules governing private foundation operations, backed up by a two-tier system of excise taxes or penalties.

B. **Restrictions on Private Foundation Operations.** The Tax Reform Act of 1969 added five provisions to the Code to address the five principal concerns raised by the Treasury Study.

1. **Self-Dealing Rules.** Congress was concerned that founders and managers of private foundations were using foundations for their own benefit. There were reports, for example, that foundations were providing loans and stock bailouts for founders, high salary payments and preferential provision of services. In response, Congress enacted the self-dealing rules which generally prohibit transactions between foundations and their founders and substantial contributors. See section 4941.

2. **Mandatory Distributions.** Congress was concerned that private foundations were being used to accumulate money tax-free without making any immediate charitable impact. In response, Congress added the mandatory distribution rules which generally require foundations to distribute for charitable purposes five percent of their assets each year. See section 4942.

3. **Excess Business Holdings.** Congress was concerned that private foundations were often too entangled in business affairs and even sometimes indistinguishable from the founders' business operations. In response, Congress passed the excess business holdings rules which prohibit a foundation from owning more than 20 percent of a "business enterprise." See section 4943.

4. **Jeopardizing Investments.** Congress was concerned that funds held by private foundations were being used for excessively risky ventures that were not producing income for charitable purposes. In response, Congress passed the jeopardy investment rules which prohibit investment of foundation funds in risky or speculative investments. See section 4944.

5. **Taxable Expenditures.** Congress was concerned that existing regulations were not adequate to insure that foundation assets and income were spent for charitable purposes. Specifically, Congress was concerned that many foundations were too involved in lobbying and political activities. Congress passed the taxable expenditures rules which imposes taxes on lobbying and political activities; grants for scholarships (unless approved in advance); and grants to other private foundations unless the granting foundation exercises "expenditure responsibility." See section 4945.

C. **Excise Taxes on Restricted Transactions**

1. **Two-tier Tax Structure.** The private foundation rules contain an excise tax regime that is designed to encourage initial compliance, immediate correction in the event of a violation, and allow for innocent mistakes. Most of the rules contain two tiers of taxes that will apply in the event of a violation. The first tier of tax applies as soon as the violation occurs and the second tier of tax

applies if the violation is not corrected within a specified period of time. Some of the rules impose additional taxes on the manager of the foundation personally where it is thought a tax on the foundation itself is an insufficient deterrent.

2. **Abatement of Taxes.** Under section 4962(a), the IRS has the authority to abate any first-tier tax (other than the first-tier tax on self-dealing) if the violation in question was due to reasonable cause and not to willful neglect.

3. **Impact on Private Foundations.** The impact of these rules on private foundations is more in terms of compliance than in risk of liability.

D. **Excise Tax on Investment Income.** The Tax Reform Act of 1969 also imposed a two percent excise tax on the investment income of private foundations. This tax was imposed to ensure that private foundations were contributing something in exchange for the protections and benefits of government. The tax was also intended to finance the increase in oversight that was required to enforce the new regulations.

V. Taxes on Self-Dealing (Section 4941)

A. Overview

On its face, section 4941 prohibits all direct and indirect financial transactions between a private foundation and specifically defined "disqualified persons." However, eight statutory exceptions and additional exceptions added by the regulations mitigate the harshness of the general rule somewhat. Nevertheless, a disqualified person may be subject to excise taxes even for an inadvertent or unknowing violation, and may be subject to excise taxes even if the self-dealing benefited the private foundation. The rules are exceedingly complex. A disqualified person, broadly defined, is anyone who controls or funds the foundation. A corporation that establishes a foundation, for example, would be a "substantial contributor" and therefore considered a disqualified person in virtually all cases. For this reason, the self-dealing rules are particularly important for corporate foundations.

B. **Disqualified Persons**. Under Section 4946(a) the term "disqualified person" includes the following:

1. **Substantial Contributors**. A substantial contributor is any person who contributed or bequeathed an aggregate amount of more than $5000 to the private foundation, if such amount is more than two 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 is received by the foundation from such person. If the private foundation is a trust, the term 'substantial contributor' also means the creator of the trust. Section 507(d)(2).

2. **Foundation Managers.** A foundation manager is

   a) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and

   b) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

3. **Twenty Percent Owners of Substantial Contributors.** An owner of more than 20 percent of a business corporation, partnership, or unincorporated business enterprise that is a substantial contributor to the foundation is a disqualified person.

4. **Family Members.** A member of the family of a substantial contributor, foundation manager or 20 percent owner of a business that is a substantial contributor is a disqualified person.

5. **Related Businesses.** A corporation, partnership or trust in which any of the above listed individuals own more than 35% of the combined voting power is a disqualified person.

6. **Typical Disqualified Persons for a Company Foundation**

   a) Sponsoring corporation

   b) Wholly-owned subsidiaries of the sponsoring corporation and other businesses in which it has a large stake

   c) If there are substantial contributors other than the corporation, business enterprises in which such substantial contributors have a significant stake

   d) Employees of the corporation who hold large stakes in the sponsoring corporation or serve as foundation managers may be disqualified persons

C. Definition of Self-Dealing

1. **Overview.** The structure of the definition of self-dealing consists of three parts: (1) Section 4941(d)(1) describes six acts that constitute self-dealing and the regulations further define these acts; (2) Section 4941(d)(2) provides eight statutory exceptions to the rules which are further defined by the regulations; and (3) the regulations provide various other exceptions (which are not covered in this outline).

2. **Statutory Definition.** Section 4941(d) defines the term "self-dealing" to mean any direct or indirect:

a) *Sale or exchange, or leasing, of property between a private foundation and a disqualified person.*

Any sale or exchange is an act of self-dealing unless it is expressly excepted from the definition. For example, the regulations indicate that the sale of supplies or a bargain sale of stock is an act of self-dealing. The transfer of property subject to a mortgage is a sale of property if the recipient assumes the mortgage liability. Any lease, other than a lease without charge and certain pre-1969 leases, is self-dealing. See Treas. Reg. section 53.4941(d)-2(a)-(b).

b) *Lending of money or other extension of credit between a private foundation and a disqualified person*

All loans are treated as self-dealing unless they fall within the regulatory exception for interest-free loans, pledges or other evidence of a future gift, and certain general banking functions provided by a disqualified person. See Treas. Reg. section 53.4941(d)-2(c).

c) *Furnishing of goods, services, or facilities between a private foundation and a disqualified person*

The regulations indicate that furnishing of office space, automobiles, secretarial help, meals, libraries, publications, laboratories, and parking lots will be self-dealing. There are exceptions for furnishing of goods, services or facilities to foundation managers and employees if the value of such furnishing is reasonable and necessary to the performance of his or her tasks in carrying out the exempt purposes of the foundation. There is also an exception for furnishing of goods, services or facilities by a disqualified person without charge. For this purpose, the furnishing of goods will be considered without charge even though the private foundation pays for insurance, transportation or maintenance costs if the payments are made to a third party. See Treas. Reg. section 53.4941(d)-2(d)(2) and (3).

d) *Payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person*

There is an exception for the payment of compensation to a disqualified person for "personal services" that are reasonable and necessary to carry out the exempt purposes of the foundation. See Treas. Reg. section 53.4941(d)-2(e); 53.4941(d)-3(c).

e) *Transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation*

If a private foundation makes a payment that satisfies a legal obligation of a disqualified person, that is self-dealing. There is an exception for incidental benefits such as public recognition (see discussion below and in Section XI). There is also an exception for indemnification of foundation managers under certain circumstances. See Treas. Reg. section 53.4941(d)-2(f).

f) *Agreement by a private foundation to make a payment to a government official*

All payments to government officials are acts of self-dealing unless the payments fall within the statutory exception in Section 4941(d)(2)(G). See Treas. Reg. section 53.4941(d)-2(g).

3. **Statutory Clarifications and Exceptions.** While the language of Section 4941 is absolute and appears to strictly prohibit the six specified transactions, Section 4941(d)(2) provides special rules to determine whether certain transactions will be considered self-dealing. These rules provide exceptions to the general rules for certain transactions that benefit the foundation but provide no gain to a disqualified person. These special rules are listed below.

a) *Transfer of property subject to a mortgage to a private foundation.* Section 4941(d)(2)(A) provides, "the transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer."

b) *Interest free loans to a private foundation.* Section 4941(d)(2)(B) provides "the lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge (determined without regard to section 7872) and if the proceeds of the loan are used exclusively for charitable purposes specified in section 501(c)(3)."

c) *Free goods, etc. used by private foundation for charitable purposes.* Section 4941(d)(2)(C) provides "the furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3)."

d) *Arms' length provision of goods, etc. to disqualified person.* Section 4941(d)(2)(D) provides "the furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public."

e) *Reasonable Compensation.* Section 4941(d)(2)(E) provides "except in the case of a government official (as defined in section 4946(c)), the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive."

f) *Certain Corporate Reorganizations.* Section 4941(d)(2)(F) provides "any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value."

g) *Government Officials.* Section 4941(d)(2)(G) provides numerous exceptions for transactions that would otherwise be deemed self-dealing between a private foundation and a government official (as defined in section 4946(c)).

h) *Pre-1969 Leases.* Section 4941(d)(2)(H) provides a narrow exception inserted as part of the Tax Reform Act of 1969 to ease the transition for certain leases or renewals of leases in effect on October 9, 1969.

4. Incidental Benefits

a) A corporate sponsor of a private foundation receives many incidental benefits from the establishment of a foundation such as goodwill and improved employee morale. In addition, through its grant making activities, it may benefit from improved community relations and have a better educated community from which to hire employees. Treasury regulations provide that such "incidental benefits" will not be treated as self-dealing. This rule is frequently the decisive factor in determining whether a corporate foundation can undertake a proposed transaction. Treasury regulation section 53.4941(d)-2(f)(2) states, "The fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing. Thus, the public recognition a person may receive, arising from the charitable activities of a private foundation to which such person is a substantial contributor, does not in itself result in an act of self-dealing since generally the benefit is incidental and tenuous. For example, a grant by a private foundation to a section 509(a)(1), (2), or (3) organization will not be an act of self-dealing merely because such organization is located in the same area as a corporation which is a substantial contributor to the foundation, or merely because one of the section 509(a)(1), (2), or (3) organization's officers, directors, or trustees is also a manager of or a substantial contributor to the foundation.

b) The Treasury regulations contain two examples relevant to incidental benefits to corporate owners of foundations.

i) Treasury regulation 53.4941(d)-2(f)(9), Example (1) states, "M, a private foundation, makes a grant of $50,000 to the governing body of N City for the purpose of alleviating the slum conditions which exist in a particular neighborhood of N. Corporation P, a substantial contributor to M, is located in the same area in which the grant it to be used. Although the general improvement of the area may constitute an incidental and tenuous benefit to P, such benefit by itself will not constitute an act of self-dealing.

ii) Treasury regulation 53.4941(d)-2(f)(9), Example (2) describes a scholarship program for children of employees of the corporation. If such a program qualifies under section 4945(g)(1), and is therefore not considered a taxable expenditure, such a program will not be considered self-dealing.

See the discussion in Section XII below for additional types of benefits to sponsoring corporations that are considered incidental.

D. Excise Taxes

1. First-Tier Taxes

a) On Disqualified Persons

i) Under section 4941(a)(1) an initial tax is imposed on any disqualified person who participated in the act of self-dealing at the rate of 5% of the amount involved with respect to each act of self-dealing for each year or partial year in the taxable period.

ii) Except in the case where the disqualified individual is a government official, this tax is imposed even though the disqualified individual had no knowledge at the time of the act that the act constituted self-dealing.

b) *On Foundation Managers*

i) Section 4941(a)(2) imposes an initial tax of 2 ½ % of the amount involved on any foundation manager who *knowingly* participates in an act of self-dealing between a disqualified person and a private foundation.

ii) The first-tier tax is imposed on foundation managers only if the following five conditions are met.

(A) There must be a tax imposed on a disqualified person by section 4941(a)(1).

(B) The foundation manager must participate in the act of self-dealing.

1. The term "participation" includes "silence or inaction on the part of a foundation manager where he is under a duty to speak or act, as well as any affirmative action by such manager." Treasury regulation section 53.4941(a)-1(b)(2).

2. "A foundation manager will not be considered to have participated in an act of self-dealing where he has opposed such act in a manner consistent with the fulfillment of his responsibilities to the private foundation." Treasury regulation section 53.4941(a)-1(b)(2).

(C) The foundation manager must know that the act is an act of self-dealing.

1. "… a person shall be considered to have participated in transaction "knowing" that it is an act of self-dealing only if--(i) He has actual knowledge of sufficient facts so that, based solely upon such facts, such transaction would be an act of self-dealing, (ii) He is aware that such an act under these circumstances may violate the provisions of federal tax law governing self-dealing, and (iii) He negligently fails to make reasonable attempts to ascertain whether the transaction is an act of self-dealing, or he is in fact aware that it is such an act." Treas. Reg. section 53.4941(a)-1(b)(3).

2. The regulation further explains, "the term 'knowing' does not mean 'having reason to know.' However, evidence tending to show that a person has reason to know of a particular fact or particular rule is relevant in determining whether he had actual knowledge of such fact or rule."

(D) The participation must be willful.

"Participation by a foundation manager shall be deemed willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurrence of any tax is necessary to make the participation willful. However, participation by a foundation manager is not willful if he does not know that the transaction in which he is participating is an act of self-dealing." Treasury regulation section 53.4941(a)-1(b)(4).

(E) The participation must not be due to reasonable cause.

1. A foundation manager's participation is due to reasonable cause if he has exercised his responsibility on behalf of the foundation with ordinary business care and prudence. Treas. Reg. section 53.4941(a)-1(b)(5).

2. Advice of Counsel. Treasury regulation section 53.4941(a)-1(b)(6) provides, "If a person, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of such counsel expressed in a reasoned written legal opinion that an act is not an act of self-dealing under section 4941, although such act is subsequently held to be an act of self-dealing, the person's participation in such act will ordinarily not be considered 'knowing' or 'willful' and will ordinarily be considered 'due to reasonable cause' within the meaning of section 4941(a)(2)."

c) *No Abatement.* As noted above, the Secretary does not have discretionary authority to abate the first-tier taxes imposed on self-dealing transactions. Section 4962(b).

2. Second-Tier Tax

a) On Self-Dealer

i) While the first-tier tax of section 4941(a)(1) is automatically imposed on a disqualified person who participates in an act of self-dealing, the second-tier tax of section 4941(b)(1) is imposed on a disqualified person only when the act of self-dealing is not "corrected" within the "taxable period."

ii) The rate of tax imposed by section 4941(b) on a disqualified person in such an instance is 200% of the amount involved.

b) On Foundation Managers

i) If an act of self-dealing is not corrected within the "taxable period," section 4941(b)(2) imposes a second-tier tax on a foundation manager of 50% of the amount involved.

ii) This second-tier tax on the foundation manager is imposed only where the foundation manager refuses to agree to part of all of the correction of the self-dealing transaction.

3. Joint and Several Liability

In any case where more than one person is liable for the tax imposed by any paragraph of section 4941(a) or (b), all such persons are jointly and severally liable for the taxes imposed under such paragraph with respect to an act of self-dealing.

4. Maximum Amount of Liability

The maximum amount of aggregate tax collectible under section 4941(a)(2) (first-tier tax) from all foundation managers with respect to any one act of self-dealing is $10,000, and the maximum aggregate amount of tax collectible under section 4941(b)(2) (second-tier tax) from all foundation managers with respect to any one act of self-dealing is $10,000. Treas. Reg. section 53.491(c)-1(b)(1).

5. Correction of Self-Dealing Transactions

a) In General

i) Section 4961(a) provides that if any "taxable event" is "corrected" during the "correction period" for the event, then any second-tier tax imposed with respect to the event (including interest, additions to tax, and additional amounts) will not be assessed, and if assessed, the assessment will be abated, and if collected, will be credited or refunded as an overpayment.

ii) The term "taxable event" includes any act (or failure to act) giving rise to liability for tax under sections 4941-4945.

iii) The term "correction period" means, with respect to any taxable event, the period beginning on the date on which the event occurs and ending 90 days after the date of mailing under section 6212 of a notice of deficiency with respect to the second-tier tax imposed on such taxable event, extended by:

(A) Any period in which a deficiency cannot be assessed under section 6213(a); and

(B) Any other period which the Secretary determines is reasonable and necessary to bring about correction of the taxable event.

iv) The terms "correction" and "correct" mean, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. Section 4941(e)(3).

b) *Sale by a Foundation to a Disqualified Person*

i) Treasury regulation section 53.4941(e)-1(c)(2) provides that to correct a cash sale of property by a private foundation to a disqualified person the sale must be rescinded where possible. That is, cash is to be returned to the disqualified person and the property is to be returned to the foundation. In order to avoid placing the foundation in a financial position worse than that in which it would have been if rescission were not required, the amount returned to the disqualified person should not exceed the lesser of: (a) the cash received by the private foundation on the sale, or (b) the fair market value of the property that was sold. Fair market value for this purpose is the lesser of the fair market value at the time of the sale or the time of rescission.

ii) If the property has already been sold by the disqualified person to a third party, rescission is not required under the regulations. However, the disqualified person is required to pay to the foundation the excess of (a) the greater of the fair market value of the property on the correction date or the amount realized by the disqualified person on the resale, over (b) the amount which would have been returned to the disqualified person under the above rules if rescission had been required. Further, in this situation, the same net profits earned by the disqualified person in excess of the profits earned by the foundation must be repaid to the private foundation.

c) *Sale to a Foundation by a Disqualified Person*

(A) Treasury regulation section 53.4941(e)-1(c)(3) provides that to correct a cash sale by a foundation to a disqualified person, the sale must be rescinded, with the foundation returning the property and the disqualified person returning the cash received. The amount received by the foundation should be the greater of: (a) the cash paid by the foundation; (b) the fair market value of the property at the time of the sale; or (c) the fair market value of the property at the time of the rescission. If the foundation has already resold the property, rescission is not required. However, the disqualified person is required to pay over to the foundation the excess of: (a) the amount which the foundation would have received if rescission had applied, over (b) the amount realized by the foundation on the sale.

(B) In addition, the disqualified person must pay to the foundation the excess of his net profits, with respect to the consideration he received from the foundation over the income derived by the foundation from the purchased property.

d) *Use of Private Foundation Property by a Disqualified Person*

i) Treasury regulation section 53.4941(e)-1(c)(4) states that the method of correction for the use of foundation property by a disqualified person is to have the disqualified person immediately cease his use of that property.

ii) The disqualified person must also pay to the foundation the excess of the fair market value of the use of the property over the amount actually paid by the disqualified person to the foundation for its use. For this purpose, fair market value is the higher of fair market value at the time of the act of self-dealing, or at the time of correction.

iii) The disqualified person must also pay to the foundation the excess of the amount the foundation would have received from the disqualified person for the use of the property if he had continued to use it over the fair market value of that use of the property. Therefore the foundation will continue to get the benefit of any compensation it would have received notwithstanding the termination of use by a disqualified person.

e) *Use of a Disqualified Person's Property by Private Foundation*

i) Treasury regulation section 53.4941(e)-1(c)(5) states that to correct an act of self-dealing resulting from the use of a disqualified person's property by the private foundation, the use must be immediately terminated.

ii) In addition, the disqualified person must pay to the foundation the excess of the amount paid to the disqualified person for such use through the termination date over the fair market value of such use.

iii) Also, the disqualified person must pay to the foundation the excess of the fair market value of the use of the property for the period the foundation would have used the property if termination did not occur over the amount which would have been paid to the disqualified person on or after the date of such termination for such use.

f) *Payment of Compensation to a Disqualified Person*

Treasury regulation 53.4941(e)-1(c)(6) provides that to correct a payment of excess compensation to a disqualified person, the disqualified person must repay to the private foundation the amount of such excess. The regulations do not provide that the compensation cease.

g) *Valuation Errors*

Treasury Regulation section 53.4941(e)-1(c)(7) provides that when a transaction would not have been an act of self-dealing had the foundation received fair market value but self-dealing does occur in spite of a good faith effort to determine fair market value, correction occurs if the disqualified person pays to the private foundation an amount equal to the amount involved (in such case, the extent of the valuation error) plus all amounts necessary to compensate the private foundation for loss of the use of the money or other property during the period commencing on the date the transaction occurred and ending on the date of correction.

VI. Taxes on Failure to Distribute Income (Section 4942)

A. Overview

Section 4942 requires that private foundations distribute a minimum amount of their investment funds on an annual basis. This minimum amount is basically 5% of the private foundation's assets held for investment rather than used for charitable purposes. In order to count towards the 5% requirement, amounts must be transferred or used for charitable purposes. Such amounts are referred to as "qualifying distributions." An excise tax is imposed on the excess of the minimum distributable amount over the qualifying distributions. The payout requirement for a specific year is calculated based on the foundation's assets for the prior year.

B. Calculating the Minimum Distributable Amount

1. **In General.** The minimum amount that a private foundation must distribute in a given year is often referred to as the minimum distributable amount. This amount is defined in section 4942(d) as an amount equal to--

   a) the private foundation's "minimum investment return"

   b) *plus* certain amounts previously treated as qualifying distributions that have subsequently been repaid to the foundation

   c) *less* any unrelated business income tax and the Section 4940 tax on foundation investment income.

2. **Minimum Investment Return**

   a) The minimum investment return is defined generally as 5% of the aggregate fair market value of all the foundation's assets other than those used or held to carry out the foundation's exempt purposes, less any indebtedness with respect to such assets. Section 4942(e)(1).

   b) *Included Assets*

   The minimum distributable amount applies to all property interests unless specifically excluded. Assets used to carry out the exempt purposes of the foundation are excluded by statute. Four other categories of assets are excluded in the Treasury regulations. These categories are generally property interests of a private foundation over which the foundation has no current investment control.

   c) *Excluded Assets*

   i) Exempt Function Assets

(A) Section 4942(e)(1)(A) excludes any assets used, or held for use, directly in carrying out the foundation's exempt purposes, from the assets of the private foundation to which the minimum distributable amount applies.

(B) Assets held for the production of income or for investment, are not considered used directly in carrying out a foundation's exempt purposes, and therefore they are not excluded from the asset base even though the income from these assets is eventually spent to carry out the foundation's exempt purpose.

ii) Nonpossessory Property Interests

(A) Any future interest of a foundation in the income or corpus of any real or personal property is excluded from the minimum distributable amount until all intervening interests in, and the rights to actual possession or enjoyment of, the property have expired.

(B) Any interest of a private foundation in the assets of an estate are excluded from the minimum distributable amount until the time the assets are distributed.

Treas. Reg. section 53.4942(a)-2(c)(2).

iii) Dual Use Assets. If property is used for exempt functions and for investment purposes (e.g., foundation owns a building that is used in part for the foundation's offices with the balance rented for commercial purposes), then an allocation must be made between exempt functions and investment purposes. If the property is used more than 95% for one purpose, then the other purpose is ignored. Treas. Reg. section 53.4942(a)-2(c)(3).

3. **Additions to Minimum Investment Return.** Under section 4942(f)(2)(c), the minimum distributable amount is increased by

a) amounts received or accrued as repayments of certain administrative expenses that were taken into account as a qualifying distribution for any taxable year;

b) amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account as a qualifying distribution for any taxable year, i.e., to the extent the property was acquired to be used for charitable purposes; and *c)* any amount set aside that was treated as a qualifying distribution to the extent it is determined that such amount is not necessary for the purposes for which it was set aside. See VI.C.4 of this outline below.

C. Qualifying Distributions

1. Overview. In general, "qualifying distributions" are distributions that are made to further a charitable purpose as defined in Section 170(c)(2)(B). They include grants to public charities and private operating foundations, so long as these organizations are not controlled by the grant making foundation, as well as direct expenditures for charitable purposes, including amounts paid for administrative expenses and the acquisition of assets to be used for charitable purposes. Section 4942(g).

2. Direct Grants

a) Grants to Public Charities

Grants to public charities are qualifying distributions so long as the charity is not controlled by the private foundation making the grant and the grant is not earmarked or otherwise still controlled by the private foundation. Grants with conditions may still be qualifying distributions, but only so long as the conditions do not impose material restrictions that prevent the organization receiving the grant from freely and effectively employing the grant in furtherance of its exempt purposes. See Treasury regulation section 1.507(a)(8).

b) Grants to Private Operating Foundations

A grant to a private operating foundation, defined in section 4942(j)(3), that is not controlled by the private foundation making the grant is a qualifying distribution.

c) Grants to Private Nonoperating Foundations and Controlled Public Charities

A grant by a private foundation to another private, nonoperating foundation or to any organization, public or private, controlled by the grantmaking foundation or by any of its disqualified persons does not constitute a qualifying distribution. The theory behind this limitation is that funds passed between private foundations or within organizations controlled by the same private foundation are not distributed for charitable purposes.

d) Grants to Foreign Organizations

A contribution to any organization, including a foreign organization, will not be treated as a qualifying distribution unless the organization has received a determination letter from the IRS that it is a public charity or a private operating foundation. There is an exception to this general rule where a private foundation makes a "good faith determination" that the foreign organization would be classified as a public charity or private operating foundation if such a determination letter was sought.

e) *Grants of Borrowed Funds and Loans as Grants*

If a private, nonoperating foundation borrows money in a particular taxable year for a specific charitable purpose, such amount will only be deemed a qualifying distribution when the amount borrowed is actually distributed for the purpose for which the funds were borrowed. See Treasury regulation 53.4942(a)-3(a)(4)(i). Interest payments with respect to any loan are not treated as qualifying distributions but may be taken as deductions against the gross income of the foundation in the year made.

3. Direct Charitable Expenditures

a) Amounts expended to directly accomplish a charitable purpose are qualifying distributions. There is no requirement that a payment be a grant to another organization to be a qualifying distribution.

b) Amounts expended to acquire an asset used directly to carry out a charitable purpose may also be included as a qualifying distribution. The category of assets considered "Assets used (or held for use) directly in carrying out the foundations' exempt purpose" is defined in Treasury regulation section 53.4942(a)-2(c)(3).

c) Administrative expenses incurred as investment expenses to manage the endowment do not count as qualifying distributions. All other necessary and reasonable administration expenses may count as "qualifying distributions." If operating expenses are not used exclusively for exempt purposes, an allocation between exempt and nonexempt functions should be made.

4. Set Asides

a) Under certain circumstances, amounts set aside for a specific project that serves a charitable purpose are treated as a qualifying distribution in the year they are set aside rather than in the year they are actually paid. Section 4942(g)(2). This provision enables private foundations to make distributions for large projects that cannot be funded in a single year.

b) To qualify as a set aside, the amount must be set aside for a specific project and must be paid out within five years of the set aside. The set aside must meet either the "suitability test" or the "cash distribution test." The cash distribution test is only available to new private foundations. Under the suitability test, the private foundation must establish to the satisfaction of the Secretary that the project is one that can be better accomplished by a set aside than by immediate payment of funds or that the project will not be completed before the end of the taxable year in which the set aside is made. The private foundation must obtain a ruling from the IRS in order for a set aside to be treated as a qualifying distribution and it must apply for a ruling before the end of the year in which the set aside is made. An example of a project that would typically qualify for a set side is a construction project that will take place over several years and requires that provision be made for payments in the later years. Treas. Reg. section 53.4942(a)-3(b).

D. Excise Taxes

1. Initial Tax

A foundation must pay a tax equal to 15% of undistributed income (i.e., the minimum distributable amount less qualifying distributions). The tax is imposed separately for each succeeding year (or part of a year) that the income remains undistributed. It is imposed on the foundation but not on foundation managers. Payment of the tax does not relieve the foundation of the requirement to make the distribution. The tax may be abated if the underpayment is due solely to a valuation error that was not willful and is due to reasonable cause. Section 4942(a); Treas. Reg. section 53.4942(a)-2(e).

2. Second-Tier Tax

A second-tier tax of 100% of income that remains undistributed at the close of the "taxable period" is imposed on the foundation. In general, the close of the taxable period is 90 days after the foundation receives a deficiency notice for the first-tier tax from the Service. Thus, the foundation can avoid the second-tier tax by making a qualifying distribution of the undistributed amount within 90 days of receiving a deficiency notice from the Service. The 90 day period can be extended by any period the Secretary determines is reasonable to bring about correction or, if the foundation contests the tax in Tax Court, until the decision of the Tax Court with respect to such deficiency becomes final. See section 4942(b); Treasury regulation section 53.4942(a)-1.

VII. Tax on Excess Business Holdings (Section 4943)

A. Limitation on Business Holdings

1. Section 4943 limits the combined ownership of a private foundation and its disqualified persons in a business enterprise to 20% of the business. A 35%

limit applies in certain circumstances if the foundation can show that effective control is in a third party that is not a disqualified person.

2. For these purposes, a business enterprise does not include a business in which more than 95% of the income is passive. Passive income is defined by reference to the passive income exceptions from the unrelated business income tax and includes dividends, interest, royalties, annuities, certain rents, and gains on the sale or disposition of capital gain. See sections 512(b)(1), (2), (3), and (5). In addition, income from the sale of goods is treated as passive if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. Section 4943(d).

3. Businesses that are related to a foundation's exempt function and program related investments are also excluded from the definition of business enterprise. Section 4943(d)(3); Treas. Reg. section 4943-10(b).

B. Excise Taxes

1. First-tier Tax

a) A private foundation which exceeds the 20 percent limit (or 35 percent limit if applicable) incurs an initial excise tax equal to 5% of the value of its "excess business holdings." The initial tax is imposed on the last day of the taxable year, but is determined as of the day during the taxable year when the foundation's excess holdings in the business enterprise are the greatest. Section 4943(a)(2).

b) In general, a foundation will not be subject to the tax on excess business holdings if it disposes of holdings it has acquired through purchase within 90 days of learning that it has excess business holdings and if it did not know or have reason to know that it had excess business holdings. For example, the foundation may not have known or had reason to know of recent acquisitions by a disqualified person. Treas. Reg. section 53.4943-2(a)(ii).

c) In general, a foundation has five years to dispose of excess business holdings acquired other than by purchase by the foundation or by a disqualified person. Treas. Reg. section 4943-6

2. Second-tier Tax

A tax equal to 200% of the value of a foundation's excess business holdings is imposed on the foundation if the excess is not cured within a stated amount of time.

VIII. Tax on Jeopardizing Investments (Section 4944)

A. Restrictions on Investments

1. In General

Section 4944 imposes an excise tax on any private foundation and its managers that make an investment which jeopardizes the carrying out of the foundation's exempt purposes.

2. Definition of "Jeopardizing Investment"

a) Treasury regulation section 53.4944-1(a)(2)(i) provides, "an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private 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.

b) The regulation further provides, "No category of investments shall be treated as a per se violation of section 4944." However, the regulation goes on to list examples of types or method of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence. Those examples include:

i) Trading in securities on margin

ii) Trading in commodities futures

iii) Investments in working interest in oil and gas wells

iv) The purchase of "puts" and "calls" and "straddles"

v) The purchase of warrants

vi) Selling short

c) "The determination whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight."

d) Section 4944(c) provides "investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(b) [charitable purposes], 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." Such investments are usually referred to as "program-related investments."

B. Excise Taxes

1. First-tier Tax

An initial excise tax of 5% of the amount of the investment is imposed on the foundation, and an equal tax is imposed on any foundation manager who knowingly participated in making the investment. A foundation manager is subject to the tax only if he has actual knowledge that the investment is a jeopardizing investment, is aware that the investment may violate the federal tax laws, and negligently fails to determine if the investment is a jeopardizing one. The Service can abate the tax if the jeopardizing investment was not willful and was due to reasonable cause. Section 4944(a).

2. Second-tier Tax

If the foundation fails to remove the investment from jeopardy, i.e., to sell or dispose of it, within a specified time, it is liable for an additional tax of 25% of the amount of the investment. A foundation manager who refuses to remove the investment from jeopardy is liable for an additional 5% tax. Section 4944(b).

3. Limitations on Taxes on Foundation Managers

If more than one foundation manager is liable for an excise tax, they are jointly and severally liable for the tax. The first-tier tax is limited to $5,000 for a single investment and the second-tier tax is limited to $10,000 for a single investment. Section 4944(d).

IX. Taxes on Taxable Expenditures (Section 4945)

A. Overview

A taxable expenditure is any amount paid or incurred by a private foundation for lobbying; intervention in political campaigns; certain grants to individuals unless approved in advance by the Secretary; grants to organizations other than public charities and private operating foundations unless the foundation exercises "expenditure responsibility;" and, grants for any purpose that is not charitable as defined in Section 170(b)(2).

B. Lobbying

1. General Definition

Section 4945(e) defines lobbying to mean any amount paid or incurred by a private foundation for

a) Grassroots lobbying: any attempt to influence any legislation through an attempt to affect the opinion of the general public or any segment thereof, or

b) Direct lobbying: any attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation.

2. Actions that Are Not Lobbying

a) technical advice or assistance provided to a governmental body or to a committee or other subdivision thereof in response to a written request by such body or subdivision,

b) making available the results of nonpartisan analysis, study, or research

c) an appearance before, or communication to, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation.

d) Except as provided in section 4945(f), to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive.

C. Political Activity

1. Prohibited Political Activity

Expenditures to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive, are taxable expenditures unless they are nonpartisan within the meaning of section 4945(f). Section 4945(d)(2).

2. Permissible Nonpartisan Political Activities. Section 4945(f) excludes from the definition of taxable expenditure nonpartisan activities that meet the following five (5) requirements:

a) The organization qualifies under section 501(c)(3) and is tax-exempt under section 501(a).

b) The activities must be nonpartisan, not confined to one specific election period, and carried on in 5 or more states.

c) The foundation must spend substantially all of its income directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated.

d) The foundation must receive substantially all its support (other than gross investment income as defined in section 509(e)) from exempt organizations, the general public, government units described in 170(c)(1), or any combination of the foregoing. No more than 25% of this support may be received from any one exempt organization and no more than half of this support may be received from gross investment income.

e) Contributions to the foundation for voter registration drives may not be subject to a condition that they may be used only in specified States, possessions of the United States, or political subdivisions or other areas of any of the foregoing, or the District of Columbia, or that they may be used in one specific election period.

D. Grants to an Individual for Travel, Study, or Similar Purposes

In order for a grant to an individual for travel, study or similar purposes to avoid classification as a taxable expenditure, such grant must be awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the Secretary. Section 4945(g) lays out the appropriate considerations for the Secretary in evaluating such a procedure.

E. Grants to Organizations

1. **Public Charities and Private Operating Foundations.** Grants to public charities (other than those described in Section 509(a)(4) regarding testing for public safety) and private operating foundations (as defined in section 4940(d)(2) are not taxable expenditures.

2. **Other Organizations.** Grants to organizations other than public charities and private nonoperating foundations are taxable expenditures unless the foundation exercises expenditure responsibility in accordance with subsection 4945(h). Expenditure responsibility means that the private foundation is responsible to exert all reasonable efforts and to establish adequate procedures (1) to see that the grant is spent solely for the purpose for which made, (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the Secretary.

F. Any Noncharitable Purpose

This is a catch-all category for any contribution by a private foundation that is not within an exempt purpose defined in section 170(c)(2)(B) as “religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.”

G. Excise Taxes

1. First-Tier Excise Tax

a) *On the Foundation.* An initial first-tier excise tax of 10% of the amount of each taxable expenditure made by a private foundation is imposed on the foundation.

b) *On the Foundation Manager.* An excise tax of 2 ½ % of the amount of the expenditure is imposed on the “agreement” of any foundation manager to make such an expenditure “knowing” that such expenditure is a taxable expenditure. This tax is not imposed if the agreement is due to “reasonable cause” and not “willful.”

2. Second-Tier Excise Tax

a) *On the Foundation.* If the taxable expenditure is not corrected within the taxable period, a tax of 100% of the expenditure is imposed on the foundation.

b) *On the Foundation Manager.* If a second-tier tax is imposed on the foundation and the foundation manager refused to agree to part or all of the correction, a second-tier tax of 50% of the taxable expenditure is imposed on the foundation manager.

3. Correction

a) “Correction” means recovering part or all of the expenditure to the extent that recovery is possible and where recovery is not possible, taking corrective action as prescribed by the Secretary. If the tax arises from failure to obtain and make reports as required by the expenditure responsibility rules, then “correction” means obtaining and making such reports. Section 4945(i)(1).

b) The taxable period (i.e., correction period) begins on the date of the expenditure and ends on the earlier of the date a notice of deficiency is received by the foundation or the first-tier tax is assessed on the foundation.

X. Tax on Investment Income (Section 4940)

A. Legislative History and Overview

1. There were two principal justifications for the tax on investment income of private foundations that was enacted as part of the Tax Reform Act of 1969. The Committee Report from the Ways and Means Committee in the House of Representatives cited that private foundations enjoy the benefits of government and therefore to some extent should bear some of the costs. Second, the committee also stated that the tax on investment income would offset the particular cost for the "vigorous and extensive administration" needed to oversee private foundations and ensure their funds were used for charitable purposes.

2. Section 4940 imposes a 2% excise tax on the net investment income of every non-operating foundation. A private foundation's net investment income is defined by the statute as its gross investment income less the ordinary and necessary expenses paid or incurred for the production or collection of such income or for the management, conservation, or maintenance of property held for the production of such income. Private foundations which meet certain distribution requirements are subject to a reduced excise tax rate of 1%.

B. Definition of Net Investment Income

1. "Net investment income" is equal to gross investment income *plus* capital gain net income *less* allowable deductions. Section 4940(c). Each of these components of net investment income is further defined below.

2. "Gross investment income" is "the gross amount of income from interest, dividends, rents, payments with respect to securities loans (as defined in section 512(a)(5)), and royalties, but not including any such income to the extent included in computing UBIT. Section 4940(c)(2).

3. "Capital gain net income" includes only gains and losses from the sale or other disposition of property held for the production of interest, dividends, rents, and royalties. It also includes gains and losses from the sale or disposition of property used in the production of UBTI. However, if the gains were subject to UBIT, they are not also subject to the investment excise tax. Losses are allowed only to the extent of gains, a rule that requires careful tax planning to ensure that losses are fully utilized. Income from municipal bonds that is exempt under Section 103 is not subject to tax and, likewise, deductions with respect to municipal bonds are limited by the rules of Section 265.

4. "Deductions" allowed for the purpose of calculating net investment income include "all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income." Depreciation must be computed using the straight line method and depletion must be determined without regard to the percentage depletion rules. Section 4940(c)(3)

C. Requirements to Reduce Net Investment Income Tax to One Percent

1. **History and Overview.** In the Tax Reform Act of 1984 Congress added section 4940(e) to the code. This provision reduces the excise tax on net investment income of private foundations who meet certain distribution requirements. The main idea behind this provision is to allow a private foundation to distribute for charitable purposes part of the money that would otherwise be paid as excise tax under section 4940.

2. **Requirements**

a) The qualifying distributions made by the private foundation during the taxable year must equal or exceed the sum of (i) an amount equal to the assets of such foundation for such taxable year multiplied by the average percentage payout of the base period, plus (ii) one percent of the net investment income of such foundation for such taxable year. These terms are defined as follows:

i) "Percentage payout" means the percentage determined by dividing--(i) the amount of the qualifying distributions made by the private foundation during the taxable year, by (ii) the assets of the private foundation for the taxable year. Section 4940(e)(3)(B).

ii) "Base period" means the five taxable years preceding the current taxable year. If an organization has not been a private foundation for five years, the base period consists of the taxable years during which the foundation has been in existence. Section 4940(e)(4).

iii) "Qualifying distribution" has the same meaning that it has for purposes of the mandatory payout requirements. Section 4940(e)(5)(A). See section 4940(e)(5)(A) and the discussion of minimum distributions above.

b) A foundation is not eligible for the reduced investment excise tax rate if has been liable for taxes on the failure to distribute income (section 4942) with respect to any year in the base period. See Section 4940(e)(2).

XI. Termination of a Private Foundation

A. Tax on Termination.

Section 507 imposes an onerous termination tax on private foundations that are voluntarily or involuntarily terminated. The tax is designed to ensure that creators of private foundations are not able to receive tax benefits for charitable contributions to a private foundation and then later allow the private foundation to become taxable. Because the creator would not lose the benefit of the tax deduction taken in a prior year, for some, the loss of exempt status was not seen as a sufficient deterrent. The termination tax can be avoided or reduced to zero if a private foundation becomes a public charity, transfers its assets to a public charity, or transfers its assets to another private foundation under section 507(b)(2).

B. Ways to Terminate a Private Foundation

There are essentially five ways to terminate a private foundation: (1) voluntary termination; (2) involuntary termination; (3) transformation of the private foundation into a public charity; (4) transfer of assets to a public charity; and (5) transfer of all its assets to one or more public charities. For corporate foundations, issues of termination most frequently arise in the context of corporate mergers and acquisitions. After the merger or acquisition, there may be two corporate foundations and a desire to merge them into one. This can be done without incurring the tax on termination by transferring the assets of one foundation to the other.

C. Transfer of Assets to Another Private Foundation

1. Section 507(b)(2) provides that, "in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee foundation shall not be treated as a newly created organization." This provision allows a private foundation to effectively terminate its existence yet avoid the termination tax by transferring its assets to another private foundation. The provision also provides that the tax attributes of the assets, including their aggregate tax benefit, carry over to the transferee foundation.

2. The mechanism by which a private foundation can terminate by transferring assets to a related private foundation and avoid paying the termination tax was clarified in Revenue Ruling 2002-28.

a) Revenue Ruling 2002-28 describes three situations having similar facts. In each of the situations the transferor private foundation is controlled by the same people who control the transferee foundation. The three situations discussed are as follows.

i) First, where a private foundation wishes to separate into three separate private foundations.

ii) Second, where a charitable trust wishes to become a not-for-profit corporation.

iii) And third, where two private foundations operated as not-for-profit corporations wish to combine and operate as a single private foundation.

b) Under Treasury regulation section 1.507-3(c)(1), section 507(b)(2) applies to a significant disposition of assets by one private foundation to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. Treasury regulation section 1.507-3(c)(2) establishes that a transfer of all of a private foundation's assets to one or more private foundations constitutes a significant disposition. Revenue Ruling 2002-28 states that a transfer of assets described in section 507(b)(2) does not constitute a voluntary termination of private foundation status unless notice of intent to terminate is given to the IRS. Since the transferor private foundation is not considered to have terminated, the 507(c) termination tax does not apply. The ruling also states that should the transferor foundation transfer all of its assets and give written notice of its intent to terminate, the termination tax would apply, but if notice is provided at least one day after all the assets have been transferred, the termination tax will be zero because the foundation will be left with no net assets.

XII. Common Issues for Corporate Foundations

A. Overview

Many issues arise in connection with a corporate foundation because of the purposes for which it is established and the close relationship between the corporation and the private foundation. Corporations typically expect to obtain certain benefits from establishing a foundation such as goodwill, enhanced public image, good community relations, and improved employee morale. Moreover, there is often a degree of overlap between corporate directors and foundation directors. The corporation and private foundation are also frequently located in the same geographic area or even the same building. The characterization of a particular expenditure typically depends on whether the benefits seen to accrue to the corporate sponsor of the foundation are viewed as incidental to the charitable purpose or as part of a quid pro quo arrangement. The most common situations that present potential pitfalls for corporate foundations are discussed below.

B. Shared Resources

1. **The Problem**. A corporation that establishes a private foundation will frequently wish to share resources such as office space, equipment, supplies and employees with its foundation to keep operating costs to a minimum.

Because the corporation will be a substantial contributor, and therefore a disqualified person, arrangements for sharing resources must be scrutinized under the self-dealing rules of section 4941.

2. **Lease of property.** The leasing of property between a disqualified person and a foundation constitutes self-dealing even if the lease is on terms that are favorable to the foundation. Section 4941(d)(1)(A). A disqualified person may, however, provide space to the foundation without charge. Treas. Reg. section 53.4941(d)-2(b)(2). If a corporation owns its own building and wants the foundation to occupy space within the building, its only option is to provide the space without charge. If the foundation pays the corporation for the space that will constitute an act of self-dealing. A lease is considered to be provided to the foundation without charge even if the foundation pays janitorial services, utilities or other maintenance, so long as the payment is not made directly or indirectly to a disqualified person. *Id.* To come within this exception, the foundation must make payments for such services directly to the provider and the provider must not be a disqualified person. If payments are made to the foundation as a reimbursement, they will be an act of self-dealing.

3. **Shared goods, services or facilities.** The furnishing of goods, services, or facilities between a disqualified person and a foundation is an act of self-dealing, but there is a statutory exception for furnishing goods, services, or facilities without charge if they are used exclusively for charitable purposes. Section 4941(d)(2)(C). Thus, a corporation may provide its foundation with supplies, the use of equipment, or the services of corporate personnel such as secretaries or accountants without charge. The corporation may, however, prefer that the foundation be self supporting.

4. **Structuring shared arrangements.** In private letter rulings, the IRS has approved arrangements that permit "sharing" of goods, services and facilities as long as the corporation and foundation enter into separate agreements with a third party for such goods, services or facilities. In PLR 9312022 (Dec. 28, 1992), for example, the Service approved an arrangement between a law firm and a private foundation who intended to share certain office supplies, leased and purchased equipment, and certain employees. Two of the foundation's directors controlled the law firm and therefore the law firm was a disqualified person with respect to the foundation. The arrangement approved by the IRS allowed the foundation and the law firm to share the costs of shared resources without being subject to taxes on self-dealing. The sharing would be accomplished through separate contractual relationships. The law firm would not charge the foundation for the use of its resources; rather the foundation would pay its share directly to the provider of resources used by the law firm. Thus, while a corporation may not lend an employee to its foundation, the corporation and the foundation may enter into separate agreements with the employee and make payments directly to the employee. Similarly, a corporation and foundation that share rented space must enter into separate

leases with the landlord and pay the landlord separately. Similar arrangements must be made for office equipment such as photocopy machines. See also PLR 9740023 (July 3, 1997) for a detailed discussion of permissible shared office and facilities arrangements.

5. **Exception for certain personal services.** There is an exception from the self-dealing rules for the payment of reasonable compensation (and reimbursement of expenses) by a foundation to a disqualified person for the performance of personal services that are reasonable and necessary to carry out the exempt purpose of the foundation. Treas. Reg. section 53.4941(d)-3(c). By way of examples in the regulations, it is clear that legal services, investment counseling and general banking services are "personal services." Under this exception, it may be possible for a corporation to provide legal, accounting, tax preparation, payroll, benefits and similar administrative services to its foundation and be paid for such services. Whether compensation is reasonable is determined under the principles of section 162. Corporate employees who provide such services should keep detailed time records of services provided. Corporations that intend to provide such services for a fee to their foundations should consider obtaining a private letter ruling.

C. Public Acknowledgment and Recognition of the Sponsoring Corporation

1. One of the reasons many corporations make charitable contributions to various causes is to enhance the corporation's reputation in the communities in which it operates. The private foundation rules generally treat public recognition received by a corporation with respect to the operation of its foundation as an "incidental or tenuous" benefit that does not constitute self-dealing. The regulations exclude the receipt of tenuous or incidental benefits from the definition of self-dealing and the Service has issued numerous rulings permitting corporate sponsors of foundations to receive public recognition for the foundation's charitable activities.

2. **Name Exposure**

    a) Corporate owned foundations typically bear the names of their corporate founders. Therefore any recognition of the foundation's contributions results in recognition for the corporate owner as well. Treasury regulation section 53.4941(d)-2(f)(9) Example 4 addresses the issue of naming. In that example, "A, a disqualified person with respect to private foundation S, contributes certain real estate to S for the purpose of building a neighborhood recreation center in a particular underprivileged area. As a condition of the gift, S agrees to name the recreation center after A. Since the benefit to A is only incidental and tenuous, the naming of the recreation center, by itself, will not be an act of self-dealing."

b) In Rev. Rul. 73-407, 1973-2 C.B. 383, a private foundation made a contribution to a public charity on the condition that the public charity change its name to that of a substantial contributor to the private foundation. The Service ruled that this arrangement was not self-dealing because the recognition the substantial contributor to the private foundation received as a result of the name change was an incidental and tenuous benefit.

c) In Rev. Rul. 77-367, 1977-2 C.B. 193, a corporation donated land and support to a private foundation to construct a replica of an early-American village. The Service ruled that the fact the village would be named after the corporation provided only an incidental and tenuous benefit to the corporation and therefore did not result in self-dealing.

d) In PLR 199939049 (July 9, 1999), the owners of a company had the company distribute land to them which was in turn donated to a private foundation for the construction of a educational institute named after the company. The Service ruled that any benefit accruing to the company from recognition associated with the institute was incidental and tenuous and therefore did not constitute self-dealing.

3. Other Publicity Efforts

a) In PLR 9235062 (June 5, 1992), a private foundation sought to take over a charitable program established to improve the social competence of children from a related for-profit corporation. The private foundation declared that it intended to distribute some of the corporation's products as gifts to the participating children. The private foundation advertised the program and the fact that the program was funded by the corporation. The private foundation's logo also included the logo of the corporation and this logo was affixed to advertising materials and materials used in the course of the program. The Service ruled that these activities did not result in self-dealing because the benefit to the corporation was incidental and tenuous

b) Fannie Mae created the Fannie Mae Foundation, part of the activities of which were to consist of an "educational outreach program" of direct-mail and television commercials. The Fannie Mae Foundation also proposed to make available a list of affordable housing lenders, nonprofit counseling organizations, and other sources of guidance in housing matters. This program was designed to promote homeownership among low and moderate income families, minorities, residents of distressed communities, and other groups underrepresented in homeownership. There was a concern that this program amounted simply to an expansive advertising campaign on behalf of Fannie Mae under the auspices of the Foundation. The Service nonetheless approved this program, holding that the program would contribute to the accomplishment of the Fannie Mae Foundation's educational goals and would only incidentally benefit the business purposes of Fannie Mae, the sponsoring corporation. See Private Letter Ruling 9614003 (Jan. 8, 1996). In a subsequent private letter ruling, the Service clarified that the mere acknowledgment of Fannie Mae as the founder and funding source of the Fannie Mae Foundation, even if the foundation were to adopt a different name, would only provide an incidental or tenuous benefit to Fannie Mae, and therefore would not result in self-dealing. See Private Letter Ruling 9626022 (Mar. 28, 1996).

D. Benefits Received in Exchange for Contributions

1. **Typical Situations.** Charities frequently provide donors with benefits in exchange for contributions, such as tickets to fundraising events, discounts on admissions to facilities, and other benefits designed to reward donors and encourage future giving. Corporate foundations that receive tickets and other benefits in exchange for a contribution to a charity often want to give them to the corporation for use by employees or distribution to clients.

2. **Use Of Benefits by Corporation.** Transfer of tickets or other benefits to the corporation will result in self-dealing. Because the sponsoring corporation is a disqualified person with respect to the foundation, the foundation would have given a disqualified person a tangible economic benefit.

3. **Use of Benefits by Foundation Managers.** Foundation managers, however, may accept these benefits. There is an exception from the self-dealing rules for provision of goods, services and facilities to foundation managers and employees if the value is reasonable and necessary to the performance of his tasks in carrying out the exempt purposes of the foundation. See TAM 8449008 (undated).

E. Fulfillment of Corporate Pledge by Foundation

Corporate officers sometimes make oral pledges to charities with the expectation that the foundation will pay the pledge. A payment by a foundation of the corporation's pledge generally will constitute an act of self-dealing. See Treas. Reg. section 53.4941(d)-2(f). Corporate officers should be careful to avoid making pledges and, instead, agree to have someone from the foundation contact the soliciting charity. The foundation can then make the gift without corporate involvement.

F. Donations to Educational Programs

1. Corporate foundations frequently make contributions to educational institutions from which their sponsoring corporations expect to hire graduates. The corporation is motivated, at least in part, by its own interest in enhancing the education that potential future employees receive. The Service

has generally held that such benefits are incidental and tenuous and thus do not result in self-dealing.

2. In Rev. Rul. 80-310, 1980-2 C.B. 319, a private foundation made contributions to a tax-exempt university to establish a program in manufacturing engineering. A corporation that was a disqualified person with respect to the private foundation making the contribution sought to employ graduates from this program as well as encourage current employees to consider enrolling in the program. The corporation and its employees would not receive any preferential treatment in enrollment or recruiting. The Service ruled that this fact was sufficient to justify the contribution as providing a public benefit. The benefits the corporation would receive from future employees who had graduated from the manufacturing engineering program was ruled to be only an incidental and tenuous benefit.

3. In PLR 8237072 (June 17, 1989), the IRS relied upon Rev. Rul. 80-310, 1980-2 C.B. 319, and ruled that a corporate foundation's donations to a tax-exempt educational institution to help with operating expenses were charitable contributions even though the foundation's sponsoring corporation anticipated employing students and graduates of the recipient educational institution.

4. In PLR 9245040 (Aug. 12, 1992), a corporate foundation established a matching program whereby gifts to educational institutions made by employees would be matched by grants from the corporation's foundation. The Service held that this program did not constitute self-dealing and any benefits received by the corporation were incidental. In this case, the benefits would be improved employee morale.

G. Scholarship Programs for Employees and their Children

1. **Overview.** Many corporations sponsor scholarships for employees or children of employees. To avoid being classified as taxable expenditures and subject to tax, grants made under scholarship programs must qualify as scholarships or fellowships under Revenue Procedure 76-47, 1976-2 C.B. 670. In addition, the foundation must obtain prior approval from the Service.

2. **Revenue Procedure 76-47**

a) *Scope*. Only "employer-related" scholarship programs must qualify under Rev. Proc. 76-47, 1976-2 C.B. 670. A scholarship program is "employer-related," if such program (1) treats some or all of the employees (or their children) of a particular company as a group from which the recipients of some or all of the grants will be drawn; (2) limits the potential grant recipients for some or all of the foundation's grants to employees (or their children) of a particular employer; or (3) otherwise gives such individuals preference or priority over other applicants.

For example, in Rev. Rul. 79-131, 1979-1 C.B. 368, the IRS ruled that a company sponsored scholarship program for all students in a particular community did not have to meet the specific requirements of Rev. Proc. 76-47, 1976-2 C.B. 670. On the other hand, a scholarship program for children of deceased or retired employees was held in Rev. Rul. 79-365, 1979-2 C.B., 389, to be subject to the requirements of Rev. Proc. 76-47, 1976-2 C.B. 670. See also Rev. Rul. 81-217, 1981-2 C.B. 217.

b) *Requirements of Rev. Proc. 76-47*

i) *Inducement.* The employer and the foundation must not use the program to recruit employees or to induce employees to continue their employment, or to compel employees to follow any other course of action sought by the employer.

ii) *Selection Committee.* The selection committee must be made up of independent members not connected to the employer.

iii) *Minimum eligibility requirements.* Applicants must meet minimum eligibility requirements for attendance at an educational institution. If there is a minimum time of employment in order to be eligible, that minimum time must not exceed 3 years. There may be no other employment requirements for eligibility.

iv) *Objective standards of selection.* Selection standards must be objective and not related to employment of recipients or their parents.

v) *Employment.* Once awarded, a scholarship may not be terminated due to recipient or recipient's parent's termination of employment

vi) *Course of Study.* Courses of study to which the scholarship may be applied may not be limited to those courses that would benefit the employer.

vii) *Other Objectives.* The scholarship program must be consistent with the purpose of enabling the individual to obtain an education solely for his or her own personal benefit as required by section 117.

viii) *Percentage Test.* The program satisfies the percentage test if the percentage of scholarships awarded does not exceed (1) 25% of the number of employees' children who were eligible and applied for the program and (2) 10% of the number of employees' children who were eligible to apply. A program may still be approved by the IRS despite the fact that it fails to meet the percentage test if the program meets all 7 other tests and the facts and circumstances indicate that the program is not being used as additional compensation or an incentive for employees.

H. Emergency Disaster Relief Programs for Employees and their Families

1. The Service initially took a benevolent view of emergency disaster relief programs for employees administered through corporate foundations, but has since backed away from this position. The most recent published consideration of this issue by the Service views such programs as a form of accident insurance provided for employees that too closely resembles compensation to be treated as charitable. The Service has not published any requirements similar to those set forth in the scholarship program area that could be met to establish an emergency disaster relief program as charitable and consistent with the exempt purposes of a corporate foundation.

2. In PLR 199914040 (Jan. 7, 1999) and PLR 199917077 (Jan. 29, 1999) the IRS reversed its ruling in two prior letter rulings approving emergency disaster relief programs. These rulings distinguished the disaster relief programs from the scholarship programs on the grounds that the rules regarding scholarship programs ensure that no more than 10 percent of eligible employees receive the scholarships. In the emergency disaster relief programs proposed, relief would go to all eligible employees. This caused the emergency disaster relief programs to function too much like employee compensation in the form of a type of insurance benefit. This benefit was seen as serving as an inducement to employment that was more of a private benefit to the corporation than a public benefit to the community at large.

XIII. Conclusion

Private foundations are subject to a strict regulatory regime that can result in substantial penalties for foundations that fail to comply with the various operational restrictions and mandates. Accordingly, corporate sponsors of foundations must devote resources for compliance with these rules. Nevertheless, for corporations that want to use charitable giving as a significant and strategic part of their businesses, private foundations offer an effective tool that lends itself to professional management and high public visibility.