

*This summary of the tax rules for private foundations will be published shortly by the Council on Foundations as Chapter 4 of **The Rules of the Road: A Guide to the Law of Charities in the United States**, by Betsy Buchalter Adler, Ingrid Mittermaier, and David Levitt.*

CHAPTER FOUR Private Foundations

The distinction between private foundations and public charities is a creation of federal tax law. In their functions, purposes and activities, private foundations are as diverse as public charities. Through grants to other organizations and through the direct conduct of charitable programs, private foundations have an impact on American society that is disproportionate to their number. As more and more private foundations extend their philanthropy outside the United States, the laws governing their activities affect grantees in other countries as well.

Private foundations are subject to the technical and often counter-intuitive rules of Sections 4940 through 4946 in addition to the general legal rules applicable to all charities. What follows is a simplified map of this complex area, designed to help the nonspecialist navigate through it.

Disqualified Persons

The concept of the disqualified person is fundamental to the regulatory framework governing private foundations. Transactions that might be entirely proper for a public charity may well be illegal for a private foundation if the transaction involves a disqualified person. Although the term is familiar from our discussion of Section 4958 in the last chapter, it means something very different in the private foundation context. For purposes of the private foundation laws, Section 4946 defines a disqualified person⁷⁸ as:

- a substantial contributor to the organization,⁷⁹

⁷⁸ For purposes of Chapter 42, the term “disqualified person” does not include a public charity, i.e., an organization that is described in Section 509(a)(1), (2) or (3). Treas. Reg. Section 53.4946-1(a)(7). For purposes of Section 4941 only, all § 501(c)(3) organizations (other than one described in Section 509(a)(4) are excluded from the definition of a disqualified person. Treas. Reg. Section 53.4946-1(a)(8). For purposes of § 4943, another private foundation is treated as a disqualified person if (a) it is effectively controlled by the same persons who control the foundation in question or (b) it receives substantially all of its funding from the same donors (or family members of the donors) who funded the first foundation. Treas. Reg. Section 53.4946-1(b).

⁷⁹ I.R.C. § 507(d)(2) contains a detailed technical definition of when a donor becomes a substantial contributor.

- a foundation manager—that is, an officer, director or trustee, or anyone having equivalent responsibilities or powers; also, for any act or omission, any employee of the foundation who has authority or responsibility for that act or omission,
- one who owns more than 20 percent of an entity that is a substantial contributor,
- a family member of anyone described in any of the preceding three categories. “Family member” includes the person’s spouse, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren,
- a corporation, partnership or trust in which persons described in the preceding four categories own more than 35 percent of the total combined voting power, profits interest or beneficial interest, respectively.

A government official as defined in section 4946(c) is a disqualified person for purposes of the self-dealing rules, but not for purposes of the other private foundation laws.

Self-Dealing Transactions

A self-dealing transaction requires two parties: a private foundation and a disqualified person. If a transaction is described in Section 4941(d)(1), it is self-dealing and a private foundation may not engage in it, unless one of the exceptions listed in Section 4941(d)(2) applies. The rules are not based on fairness or the rule of reason. They are far-reaching and their reach often surprises those who are not familiar with them. It is remarkably easy to commit an inadvertent violation of Section 4941, thus creating a problem that can be difficult and costly to solve. It is essential, therefore, to review the self-dealing rules with care before engaging in any transaction involving a disqualified person, so that the transaction may be restructured, or if necessary avoided, in order to comply with Section 4941.

Sales, Exchanges and Leases. The sale, exchange or lease of property between a private foundation and a disqualified person is self-dealing.⁸⁰ A disqualified person may, of course, permit a private foundation to use the disqualified person’s property without charge.⁸¹ For example, it is common for company foundations to operate from the company’s office and for family foundations to operate from the family home or from the business office of a family member. But Section 4941 bars the foundation from paying any rent to a disqualified person, no matter how reasonable the amount of the rent may be.

The self-dealing ban does not, of course, apply to a disqualified person’s donation of property to a private foundation. If the disqualified person’s property is mortgaged, however, the private foundation may not assume the mortgage.⁸² It is also considered self-dealing if the

⁸⁰ I.R.C. § 4941(d)(1)(A).

⁸¹ I.R.C. § 4941(d)(2)(C).

⁸² I.R.C. § 4941(d)(2)(A). This transaction would also be barred by I.R.C. § 4941(d)(1)(E), which bans the use of a private foundation’s assets by or for the benefit of a disqualified person.

property is subject to a mortgage which a disqualified person placed on the property within the ten-year period ending on the date of the transfer to the private foundation.

Extension of Credit. Self-dealing includes the lending of money or any extension of credit between a private foundation and a disqualified person.⁸³ There is only one exception: a disqualified person may loan money to a private foundation if the loan is without interest or other charge and the proceeds are used exclusively for Section 501(c)(3) purposes.⁸⁴

Goods, Services or Facilities. Self-dealing also includes the furnishing of goods, services or facilities between a private foundation and a disqualified person.⁸⁵ But here, as above, if the disqualified person provides the goods, services or facilities without charge and the foundation uses them exclusively for Section 501(c)(3) purposes, the rule does not apply. In addition, a private foundation may furnish goods, services or facilities to a disqualified person if it is on a basis no more favorable than that on which they are provided to the general public.⁸⁶

Compensation and Expenses. A private foundation may not pay compensation to a disqualified person, nor pay nor reimburse the expenses of a disqualified person, unless two conditions are both met. First, the compensation must be for certain types of personal services that are reasonable and necessary to carrying out the foundation's exempt purposes. Second, the amount of compensation, payment or reimbursement must be reasonable and not excessive under the circumstances.⁸⁷

Transfer or Use of Income or Assets. Section 4941(d)(1)(E) is a general provision that traps any transactions of private foundations and disqualified persons that might not have been included in the preceding sections. It bars the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Private foundations are often funded with shares of stock or other investments in enterprises owned or controlled by disqualified persons. Company foundations are often supported by gifts of stock in the company itself. The self-dealing rules, taken literally, would appear to prevent the company from redeeming shares held by the foundation. Fortunately, a specific exception to the self-dealing rules provides that redeeming shares of stock between a private foundation and a corporate disqualified person pursuant to a liquidation, merger, redemption or similar corporate reorganization is not self-dealing if: (1) all of the securities of the same class as that held by the foundation are subject to the same terms and (2) those terms provide that the foundation will receive no less than fair market value for the securities.⁸⁸

⁸³ I.R.C. § 4941(d)(1)(B).

⁸⁴ I.R.C. § 4941(d)(2)(B).

⁸⁵ I.R.C. § 4941(d)(1)(C).

⁸⁶ I.R.C. § 4941(d)(2)(D).

⁸⁷ I.R.C. § 4941(d)(2)(G).

⁸⁸ I.R.C. § 4941(d)(2)(F).

Transactions with Government Officials. A private foundation may not make, or agree to make, any payment of money or transfer of property to a government official.⁸⁹ However, Section 4941(d)(1)(F) permits a private foundation to agree to employ a government official after the termination of his or her government service if that service will terminate within 90 days.⁹⁰

Correction and penalties. The IRS automatically imposes a penalty tax on the self-dealer at the rate of 10 percent of the amount involved. A penalty tax of 5 percent of the amount involved (up to a maximum tax of \$20,000 for each act of self-dealing) may also be imposed on a foundation manager—that is, a board member, officer, trustee or senior executive employee—who participated knowingly in the self-dealing transaction, unless it was not willful and was for reasonable cause.⁹¹ The foundation manager has a complete defense if he or she relied upon the advice of counsel, expressed in a reasoned written legal opinion, in the matter.⁹² For each act of self-dealing not corrected within a specific period, the self-dealer must pay an additional tax of 200 percent of the amount involved. The IRS may impose an additional penalty tax on the foundation manager of up to 50 percent of the amount involved, but only up to \$20,000.⁹³ Finally, if a foundation's self-dealing transactions are repeated or willful, the IRS may terminate the foundation's tax-exempt charitable status and impose a substantial termination tax.⁹⁴

An act of self-dealing is corrected by reversing it and placing the charity in at least as good a position as it would have been in if the self-dealing had not taken place.⁹⁵ Because the facts in a self-dealing transaction are likely to be intricate, it is important to be sure that the correction is not itself an act of self-dealing.

Example: Jones, a disqualified person, borrowed funds from a private foundation. When Jones learned that this was a self-dealing transaction, he proposed to repay the loan immediately by transferring to the foundation some land with a fair market value equal to the balance of the loan. The IRS ruled⁹⁶ that the transfer of the property would be self-dealing, because it would amount to the sale of the property to the foundation in return for the cancellation of the debt. Moreover, the

⁸⁹ I.R.C. § 4941(d)(1)(F).

⁹⁰ The ban on payments to government officials also does not apply to the types of payments described in I.R.C. § 4941(d)(2)(G).

⁹¹ I.R.C. §§ 4941(a), 4941(c)(2).

⁹² Treas. Reg. § 53.4941(a)-1(b)(6).

⁹³ I.R.C. §§ 4941(b), 4941(c)(2).

⁹⁴ I.R.C. § 507.

⁹⁵ Treas. Reg. § 53.4941(e)-1(c)(1).

⁹⁶ Rev. Rul. 81-40, 1981-1 C. B. 508.

correction would be incomplete, because the foundation would not be placed in a similar or better position; instead, it would have the cost and delay of converting the property to cash.

Mandatory Distributions

Federal tax law does not formally require public charities to spend a particular amount or proportion of their assets each year.⁹⁷ Private foundations, however, must comply with Section 4942. That statute requires a private foundation to make qualifying distributions (as defined below) each year in an amount equivalent to 5 percent of the fair market value of the foundation's noncharitable assets.⁹⁸ If the foundation holds assets for charitable purposes, however, such as art works owned by a museum that is a private foundation, those assets are not included in the base on which the payout requirement is computed.

Computing the Minimum Distribution Requirement. To determine its minimum required distributions for the year, the private foundation must compute the value of its assets. These values are computed differently according to the nature of each asset. Cash and marketable securities are valued monthly and then averaged to compute the value for the foundation's taxable year. Other assets, such as royalties, are valued once a year; land and buildings may be appraised every five years. The total asset values are then multiplied by 5 percent to reach the amount that the foundation must distribute during the following year. For example, the minimum amount that a foundation must distribute in a taxable year ending in 2001 is 5 percent of what its noncharitable assets were worth during the taxable year ending in 2000, less the excise tax paid during the year on the foundation's investment income.⁹⁹

Qualifying Distributions. Qualifying distributions include all amounts, including grants or other actual charitable distributions as well as reasonable and necessary administrative expenses, paid to accomplish one or more exempt purposes.¹⁰⁰ Amounts paid to acquire an asset

⁹⁷ An exception applies in the case of Type 3 supporting organizations, as further discussed in Chapter 3.

⁹⁸ This payout requirement is substantially lower than the distribution requirements imposed in several other nations. See Thomas Silk, *Philanthropy and Law in Asia*, supra n. 36; Carole S. George, *International Charitable Giving: Laws and Taxation* (1999); Lester M. Salamon, *The International Guide to Nonprofit Law* (1997).

⁹⁹ Treas. Reg. 53.4942(a)-2(c), generally.

¹⁰⁰ However, a grant to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons with respect to the foundation, or to most private foundations do not qualify. Section 4942(g)(1)(A). 2006 legislation also limits the ability of a private foundation to make qualifying distributions to certain supporting organizations. Section 4942(g)(4). Specifically, a private foundation cannot make a qualifying distribution to a supporting organization that is controlled directly or indirectly by one or more of the private foundation's disqualified persons, or whose supported organizations are controlled by such persons. In addition, a private foundation cannot make a qualifying distribution to a Type III supporting organization unless it is considered to be "functionally integrated," as described by reference to Section 4943(f)(5)(B). See Chapter 3 for a further discussion of the new supporting organization provisions implemented in 2006.

used directly in carrying out an exempt purpose, such as when a private foundation museum buys a work of art for exhibit, are also treated as qualifying distributions.¹⁰¹

From time to time a private foundation may have a philanthropic effort in mind that requires more funds than the foundation has on hand in the current year. In such a case, Section 4942(g)(2) permits the foundation to set aside funds for later distribution and to count the set-aside amount as a qualifying distribution in the year in which the funds are set aside, even though the funds are not actually distributed in that year.¹⁰²

If a private foundation has not distributed the minimum amount required by law in one year, it can make up the shortfall through qualifying distributions during the next year. Similar flexibility is available for a foundation that distributed more than the required amount. A private foundation may carry forward, for up to five years, any qualifying distributions above the minimum distribution amount. These excess distributions may be applied to reduce the amount that the foundation would otherwise have to distribute in the subsequent year.

Correction and Penalties. If a private foundation fails to distribute the required amounts, the IRS imposes an initial tax on the foundation of 30 percent of the amount that should have been distributed. The foundation must correct the failure within a specified period. If not, the IRS imposes an additional tax equal to 100 percent of the amount that remains undistributed. As with self-dealing, repeated or flagrant violations may lead to the withdrawal of tax-exempt charitable status and the imposition of a termination tax.

Excess Business Holdings

Section 4943 provides that a private foundation and its disqualified persons together may own no more than 20 percent of the voting or ownership interest in a business enterprise. Correcting an excess business holdings problem may require the foundation and its disqualified persons to sell assets that they would prefer to retain and to sell them within a time that may be economically disruptive if not punitive. Thus, it is important to monitor the ownership levels of foundations and their disqualified persons and to structure transactions with Section 4943 in mind.¹⁰³ Fortunately, there are several exceptions to the rule.

One particularly useful exception is the 2 percent de minimus rule. Under this rule, Section 4943 does not apply at all if the foundation, together with all other private foundations under common control or primarily funded by the first foundation's disqualified persons, owns (a) less than 2 percent of the voting stock and (b) less than 2 percent of the value of all outstanding shares of all classes of stock.¹⁰⁴ Partnerships and other unincorporated ventures are subject to a similar rule.¹⁰⁵

¹⁰¹ I.R.C. § 4942(g)(1)(B).

¹⁰² Treas. Reg. § 53.4942(a)-3(b)(1).

¹⁰³ The Pension Protection Act of 2006 applies the excess business holding rules to certain types of supporting organizations, in addition to private foundations. IRC Section 4943(f)(3)-(7).

¹⁰⁴ I.R.C. § 4943(c)(2)(C).

If the activity in question is not a business enterprise, as that term is defined for purposes of Section 4943, the statute does not apply and the private foundation's ownership percentage is not limited by law. The statute defines "business enterprise" to exclude businesses that derive at least 95 percent of their gross income from passive sources and businesses that are functionally related to the foundation's exempt purposes.¹⁰⁶ For example, a private foundation could own an unlimited interest in a holding company whose assets consisted entirely of rental real estate. A private foundation whose purpose is to assist people with physical disabilities could own 100 percent of a wheelchair factory in a developing country because that product is functionally related to the foundation's purposes.

Finally, a private foundation and its disqualified persons may own up to 35 percent of a business enterprise if a third party effectively controls the management and policies of the enterprise.¹⁰⁷

Correction and Penalties. If the holdings of a private foundation and its disqualified persons exceed the permitted percentage, investments must be sold—by the foundation, the disqualified persons or both—to reduce the holdings to the proper level. If the problem arises other than from a purchase (for example, through a gift or bequest of stock), the owners have five years in which to dispose of the excess holdings. The IRS may extend this period for five more years for an unusually large gift or bequest if the foundation establishes that the facts and circumstances warrant the extension of additional time. If there are excess business holdings because of a purchase, however, no extensions are available and the matter must be corrected promptly or the foundation will be subject to a tax equal to ten percent of the value of the excess holdings, determined as of that day during the tax year when its holdings were the greatest.¹⁰⁸

Jeopardizing Investments

Section 4944 provides that if a private foundation invests in a way that is likely to jeopardize its ability to carry out its exempt purposes, the foundation is taxed at 10 percent of the amount so invested for each year (or partial year) in the taxable period. A foundation manager who participated in making that investment, knowing that it could jeopardize the foundation, is also taxed at 10 percent of the amount unless the manager's participation was not willful and was due to reasonable cause. If the investment is not "removed from jeopardy" within the taxable period, additional taxes are imposed.

Although this statutory rule appears forbidding, in practice it rarely presents problems for foundations. Under both the Regulations to Section 4944, the Uniform Management of Institutional Funds Act, the Uniform Prudent Investor Act, and the prudent

¹⁰⁵ I.R.C. § 4943(c)(3).

¹⁰⁶ I.R.C. § 4943(d)(3).

¹⁰⁷ Section 4943(c)(2)(b); Treas. Reg. Section 53.4943-3(b)(3)(iii).

¹⁰⁸ I.R.C. §§ 5943(c)(6),(c)(7),(a).

investor rule of the Restatement of Trusts 3d, no investment is per se improper. Rather, the general approach is to look at the entire investment portfolio of the charity as a whole.¹⁰⁹ Indeed, the former general counsel of the Council on Foundations has argued convincingly that private foundations that invest only in government securities and other fixed-income investments, without diversifying their investment portfolio to include stocks and other growth investments, may be violating their fiduciary duty.¹¹⁰

Section 4944(c) specifically excludes program-related investments from the definition of jeopardizing investments. A program-related investment is an investment whose primary purpose is to accomplish one or more charitable purposes and no significant purpose is the production of income or the appreciation of property.¹¹¹ A private foundation whose goals include the relief of poverty, for example, might make a program-related investment to attract new employers to an economically depressed area.¹¹²

Taxable Expenditures

Section 4945 imposes penalties on private foundations that make taxable expenditures and on any manager who, knowingly and without reasonable cause, participates in the making of a taxable expenditure. If the taxable expenditure is not reversed, additional penalties are imposed.¹¹³

Put simply, a taxable expenditure is any expenditure that a private foundation is not allowed to make. Taxable expenditures include lobbying, as defined by Section 4945(e); attempting to influence the outcome of any specific public election or conducting or funding a voter registration drive, except as provided in Section 4945(f); making grants to individuals for travel, study or similar purposes unless the grantee selection procedures satisfy the requirements of Section 4945(g); grants to organizations that are not public charities, unless the foundation exercises expenditure responsibility over the grant as described in Section 4945(h) or, for foreign charities, the foundation determines that the grantee is the foreign equivalent of a public charity;

¹⁰⁹ Compare Treas. Reg. § 53.4944-1(a)(2) with Rest. (Third) of Trusts (Prudent Investor Rule), § 227 (1992).

¹¹⁰ John A. Edie and Lowell S. Smith, "Investing in U.S. Securities Is a Violation of Your Fiduciary Duty," *Foundation News & Commentary* (November/December 1993); Edie and Smith, "Let Go of Your Old Investment Assumptions," *Foundation News & Commentary* (January/February 1994).

¹¹¹ Treas. Reg. § 53.4944-3(a)(1). For more information, see Christie I. Baxter, *Program-Related Investments: A Technical Manual for Foundations* (John Wiley & Sons, 1997).

¹¹² A private foundation may treat amounts expended in connection with a program-related investment as qualifying distributions under Section 4942 in the year made. Treas. Reg. §53.4942(a)-3(a)(2)(i).

¹¹³ The initial tax on a taxable expenditure is 20 percent of the expenditure, paid by the foundation itself. A foundation manager who agreed to the expenditure, knowing that it was a taxable expenditure, must pay a tax equal to 5 percent of the amount involved, subject to a ceiling of \$10,000. If the error is not corrected promptly, the foundation must pay a second-tier tax equal to 100 percent of the amount involved. In addition, any foundation manager who did not agree to all or part of the correction must pay a tax equal to 50 percent of the amount, up to a ceiling of \$20,000. I.R.C. §§ 4945(a), (b), (c).

and expenditures other than for charitable purposes. Fortunately, the cited statutes and the accompanying Regulations allow a significant amount of flexibility.

Private Foundations and Advocacy. Private foundations are subject to more stringent lobbying limits than public charities. They may not conduct or pay for any type of lobbying activity except for self-defense lobbying, as described in the next chapter. Many advocacy efforts fall outside the definition of lobbying in the Regulations, however, and private foundations may conduct such efforts.¹¹⁴ In addition, private foundations may grant funds to a public charity for a specific project that includes some lobbying activity, so long as the amount of the grant is less than the nonlobbying component of the project. The next chapter discusses these opportunities in more detail.

Grants to Individuals. Private foundations may make grants to individuals, but only if the selection procedures are objective and nondiscriminatory and if the IRS has formally determined before implementation of the grants program that the foundation's selection procedures meet that standard.¹¹⁵

Expenditure Responsibility. Private foundations may fund the charitable activities of organizations other than public charities (or their foreign equivalents) if the private foundation exercises expenditure responsibility over the grant. Private foundations must also use expenditure responsibility for grants to any supporting organization where the grant is not a qualifying distribution under Section 4942. [FN: See the discussion in footnote [100]] Expenditure responsibility refers to a process of documented monitoring and oversight that consists of four elements: a pre-grant inquiry, a written grant agreement containing certain specific terms and conditions,¹¹⁶ a written report from the grantee, and the provision of information to the IRS on Form 990-PF.¹¹⁷ When a private foundation grants funds directly to a foreign charity, expenditure responsibility is required unless the foreign grantee can demonstrate that it is the equivalent of a U.S. public charity, as Chapter 6 explains.

Many private foundations, especially those without professional staff, hesitate to make expenditure responsibility grants because of the additional paperwork required. In fact, except for the Form 990-PF reporting (which is simple), many foundations already monitor

¹¹⁴ For a more detailed discussion of private foundations, advocacy and lobbying, see Colvin, "A Case Study in Using Private Foundation Funds to Educate Voters," 6 *Journal of Taxation of Exempt Organizations* 243 (May/June 1995).

¹¹⁵ The requirements for the selection procedure may be found at Treas. Reg. § 53.4945-4(b).

¹¹⁶ The agreement must require the grantee to repay any portion of the grant that is not used for the specific purposes of the grant; to submit detailed annual reports to the grantor on how the funds were spent and the progress made by the grantee in accomplishing the purposes of the grant; to maintain records of revenues and expenditures and to make its financial records available for review by the grantor at reasonable times; and not to use any of the funds to attempt to influence legislation, to influence the outcome of any specific public election, to carry on any voter registration drive, to make any grant which does not comply with the applicable private foundation grant rules or to conduct any activity for a noncharitable purpose.

¹¹⁷ Treas. Reg. §53.4945-5(b), generally. Also see Treas. Reg. §53.4945-6(c), adding the requirement that grantees hold expenditure responsibility grants in a separate fund.

grants for specific projects as required for expenditure responsibility grants. Private foundations that wish to fund grantees other than public charities do not need to be deterred from doing so by the expenditure responsibility requirements. Counsel or accountants who are familiar with these rules can work with foundations to design master forms and procedures that not only comply with the law but are also easy to administer.

Excise Tax on Net Investment Income

Like other tax-exempt organizations, private foundations generally pay no income tax. Under Section 4940, however, a private foundation must pay an annual excise tax equal to 2 percent of its net investment income. If the foundation's charitable expenditures exceed a specified minimum amount based on the foundation's average expenditures over the preceding five years, the excise tax may be reduced to 1 percent of the foundation's net investment income.¹¹⁸

The foundation's net investment income is computed by determining the foundation's gross investment income—dividends, interest, royalties, rents, certain capital gains and the like—and subtracting from that figure the ordinary and necessary expenses incurred by the foundation for the collection of that income or for the management, conservation or maintenance of income-producing property.¹¹⁹ The tax is paid in quarterly installments of estimated tax.¹²⁰

¹¹⁸ I.R.C. § 4940(e).

¹¹⁹ I.R.C. § 4940(c).

¹²⁰ I.R.C. § 6655(c).