Running Your Own Charity:
Legal Basics of Private Foundations
# Table of Contents

- **PAGE 4** OVERVIEW
- **PAGE 7** TRANSACTIONS WITH DISQUALIFIED PERSONS: SELF-DEALING
  - PAGE 7 Sale, Exchange, or Leasing of Property
  - PAGE 7 Lending of Money or Other Extension of Credit
  - PAGE 8 Furnishing of Goods, Services, or Facilities
  - PAGE 8 Payments of Compensation or Expenses
  - PAGE 9 Other Transfer or Use of the Income or Assets of a Private Foundation
  - PAGE 9 Payments to Government Officials
- **PAGE 11** MANDATORY DISTRIBUTIONS
- **PAGE 12** EASY DISTRIBUTIONS, HARDER DISTRIBUTIONS, AND TAXABLE EXPENDITURES
  - PAGE 12 Grants to Organizations
  - PAGE 12 The New Exception: Grants to “Type III” Supporting Organizations That Are Not “Functionally Integrated” Are Not Qualifying Distributions and Are Taxable Expenditures
  - PAGE 14 Grants to Individuals
  - PAGE 14 Expenditures for Non-Charitable Purposes
  - PAGE 14 Influencing Legislation
  - PAGE 15 Influencing Elections and Carrying On Voter Registration Drives
  - PAGE 15 Penalties for Taxable Expenditures
- **PAGE 16** EXCESS BUSINESS HOLDINGS
- **PAGE 17** JEOPARDIZING INVESTMENTS
- **PAGE 19** INVESTMENT INCOME TAX
- **PAGE 20** FEDERAL TAX RETURN FILING AND PUBLICITY REQUIREMENTS
- **PAGE 21** APPENDIX
OVERVIEW

Private foundations are exempt from federal income taxes but regulated more heavily than other charities, largely through the federal tax system.

Various provisions of the Internal Revenue Code (the “Code”) require foundations to:

• avoid transactions with their donors or parties related to their donors

• distribute or use a minimum amount of their assets regularly for their charitable purposes

• make distributions only to defined classes of beneficiaries

• divest themselves of large holdings in any one business

• avoid inappropriately risky investments

• pay an excise tax of 1 or 2 percent on their investment income

• make their tax documents available for public inspection

Private foundations, like all other charities, must acknowledge contributions in writing to allow their donors to claim charitable deductions for income tax purposes.

It helps to understand the rationale behind the rules.

• The Tax Reform Act of 1969 put the private foundation rules into place based on a concern that charities funded by one donor or one family presented generous opportunities for tax abuse.

• The IRS nightmare scenario: Donors transfer one-third of the stock in their thriving family business to their newly formed foundation. They claim a charitable contribution deduction for the gift for income tax purposes. They continue to control the stock as officers and directors of the foundation but make few distributions for charitable purposes. They and their children all serve as employees of the foundation, which pays them high salaries for their work. In case it ever becomes inconvenient to have stock in the hands of the foundation rather than the family, the other stockholders have the right to buy the stock from the foundation at a low price fixed in a buy-sell agreement.

• Although most foundation managers would never consider abusive transactions, the Code seeks to prevent through rigid private foundation rules even the possibility of situations like the one described above.

• Foundations created by corporations are subject to the same rules, although the likelihood of tax abuse connected with corporate giving may be significantly
lower. In the case of foundations created by individuals, the concern the private foundation rules try to prevent is subsidizing private transactions – which may be perfectly acceptable in other contexts – with a charitable contribution income tax deduction to the foundation’s donor. For a corporation, expenditures that run through a foundation might be deductible as business expenses or charitable contributions.

PRIVATE FOUNDATION AND PUBLIC CHARITY

The distinction between private foundations and public charities is important to foundations and their donors.

• Public charities are:
  1. organizations that have broad public support, as defined by their meeting either of the two tests in Code sections 509(a)(1) and 509(a)(2); or
  2. “supporting organizations,” defined in Code section 509(a)(3), that are not themselves publicly supported but that
     • have close ties with one or more publicly supported organizations
     • exist to benefit or further the purposes of that organization or those organizations
     • are presumed to be under the supervision of the supported organizations

• Private foundations are charities that are not public charities.

• Both private foundations and public charities are considered tax-exempt charities (despite the excise tax on private foundations), often referred to as “501(c)(3)” organizations because both private foundations and public charities are described in Code section 501(c)(3).

• The distinction between private foundations and public charities is often expressed by reference to one or more Code sections. The Code being what it is, there are different sections that can be used. The distinction is sometimes also stated in terms of the maximum deduction allowed for contributions of cash to the organization as a percentage of the donor’s modified adjusted gross income – 50 percent for public charities or 30 percent for private foundations. The following summarizes the terms one is likely to encounter:

Charities Generally
Both Private Foundations and Public Charities

501(c)(3)
170(c)

Public Charities
509(a)(1)
509(a)(2)
509(a)(3)
170(b)(1)(A)
50% charities

Private Foundations
30% charities

The distinction between public charities and private foundations matters to private foundations because it is easy for a private foundation to make grants to a public charity and more difficult, though not impossible, for a private foundation to make grants to anyone else. This issue is discussed beginning on page 12.

DISQUALIFIED PERSONS

Another important concept is the “disqualified person.” Disqualified persons are “insiders” - individuals and organizations that have, or are likely to have, a close relationship with a private foundation. Note that a corporation or other entity can be a disqualified person, despite the ordinary meaning of the term “person.” Transactions with disqualified persons are disfavored, as

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discussed in more detail below. Disqualified persons are, more specifically:

- Substantial contributors to the foundation. A substantial contributor is someone who gives or bequeaths more than $5,000 to the foundation if that person’s gift is also more than 2 percent of the total contributions made up through the tax year of the gift.

- Foundation managers, consisting of the foundation’s officers, directors, and trustees. For a particular act, any employee who has authority or responsibility for performing that act will also be considered a foundation manager.

- Persons who own more than 20 percent of a business that is a substantial contributor.

- Family members of substantial contributors and foundation managers, defined as their spouses; ancestors; children; grandchildren; great-grandchildren; and the spouses of their children, grandchildren, and great-grandchildren.

- Corporations, partnerships, trusts, and estates in which substantial contributors or foundation managers have more than a 35 percent interest. This includes affiliates of a corporation that is a disqualified person.

- Solely for purposes of the self-dealing rules, many government officials are considered disqualified persons.
TRANSACTIONS WITH DISQUALIFIED PERSONS: SELF-DEALING

A private foundation is prohibited from engaging in any act of “self-dealing,” meaning most forms of transaction between itself and any disqualified person, regardless of whether the transaction benefits or harms the private foundation.

The penalty for self-dealing is a tax on the disqualified person of 10 percent of the amount involved. Any foundation manager who knowingly participates in a self-dealing transaction will be subject to a tax of 5 percent. If the transaction is not “corrected” in a reasonable time, a tax of 200 percent will be imposed on the disqualified person and a tax of 50 percent will be imposed on the foundation manager.

- “Correction” means undoing the transaction in whatever way possible, with the overriding concern being that the foundation must be no worse off than it would have been had the transaction never occurred.

- The reasonable time for correction ends 90 days after the date the IRS mails an official “notice of deficiency” about the self-dealing.

- As the tax structure suggests, the taxes are designed to prevent self-dealing, not to raise revenue for the government.

- Taxes on foundation managers are capped at $20,000 for each of the first-level 5 percent tax and the second-level 50 percent tax.

There are six basic types of prohibited self-dealing transactions. All these basic types of transactions are subject to numerous exceptions and elaborations.

SALE, EXCHANGE, OR LEASING OF PROPERTY

The sale, exchange, or leasing of property between a private foundation and a disqualified person is generally self-dealing, whether the seller, lender, or lessor is the foundation or the disqualified person. Prohibited transactions include having a foundation take property subject to a mortgage that a disqualified person placed on the property within the 10-year period prior to the date of transfer.

- The leasing of property by a disqualified person to a private foundation without charge is not an act of self-dealing.

- Leases without charge are, however, a bad deal for the disqualified person. The income tax rules generally deny a deduction for contributions of “partial interests” to charity. The relevant regulations indicate that a lease interest is a partial interest for these purposes and therefore deny the donor any deduction for the interest-free lease. By contrast, if the donor contributed the cash needed for the foundation to lease property from an unrelated party, the donor would get a deduction.

LENDING OF MONEY OR OTHER EXTENSION OF CREDIT

The lending of money or other extension of credit between a private foundation and a disqualified person generally constitutes self-dealing.

- General exceptions to this rule are loans without interest from a disqualified person to a foundation, to be used exclusively for charitable purposes; the promise or pledge of a future charitable gift; and the performance of reasonable and necessary general banking functions for a private foundation by a disqualified person bank or trust company.
• Loans without interest can be an even worse deal than rent-free leases for the donor.

(a). As indicated above, it appears that the partial-interest rule denies the donor a deduction for the interest he or she could have earned, even though this interest is in effect a gift to the foundation.

(b). In addition, the Code generally “imputes” interest in the case of loans that are interest-free or bear interest at less than market rates, as defined in monthly rulings issued by the federal government. Temporary regulations provide an exception if the total loans from the lender to the foundation never exceed $250,000. Under proposed regulations that may someday replace the temporary regulations (which have been in place since 1985), the exception drops to $10,000. If a loan exceeds the threshold – currently $250,000 – the lender gets the worst of both worlds: he or she must recognize the income that would have been received if the loan bore interest, but gets no deduction for what is in effect a gift of the interest to the foundation.

• A better option than an interest-free loan may be for the donor to guarantee the foundation’s loan from an unrelated lender. The IRS has found, at least in “private letter rulings” – which are not legal precedent but indicate the way the IRS looks at issues – that a guarantee by a disqualified person can be the provision of a service at no charge and therefore not self-dealing. Contributions by the donor to help the foundation pay the interest charges may then be deductible to the donor.

FURNISHING OF GOODS, SERVICES, OR FACILITIES

As the rule for loans suggests, in general the furnishing of goods, services, or facilities by a disqualified person to a private foundation constitutes self-dealing, unless the goods, services, or facilities are furnished without charge. If a private foundation furnishes goods, services, or facilities to a disqualified person, it will not be an act of self-dealing provided that the goods, services, or facilities are made available to the general public on at least as favorable a basis as the goods, services, or facilities are made available to the disqualified person.

There is also a major exception, as discussed below, for personal services rendered by a disqualified person to a foundation.

PAYMENTS OF COMPENSATION OR EXPENSES

The payment of compensation and the reimbursement of expenses by a private foundation to a disqualified person can be self-dealing.

• However, a private foundation may pay reasonable compensation to a disqualified person, other than a government official, for personal services that are reasonable and necessary to carry out the exempt purposes of the foundation, as long as the compensation is not excessive.

• The issue of excessive compensation is obviously major. Foundations should consult available data about compensation levels and consider the time and skill involved in the work and the effective hourly rate at which a disqualified person is compensated. Would an unrelated party receive the same level of compensation?

• The form of application for recognition of 501(c)(3) status, as revised in June 2006, introduces questions about a foundation’s conflict of interest practices, with a particular focus on compensation. The exemption application asks the organization whether it has adopted a conflict of interest policy along the lines provided by the IRS and, if the organization has not done so, what its conflict of interest procedures are.

(a). The likely result is that an organization not adopting either the IRS procedures or those substantially similar will have a difficult time having its exemption recognized.

(b). Although the new procedures are not required of organizations with existing tax-exempt status, it is clear the IRS would like them to be considered a “best practice” for all 501(c)(3) organizations.

(c). A copy of the IRS conflict of interest policy is provided as the Appendix in this document.

• The “reasonable and necessary services” requirement is also important and perhaps easier to overlook than the question of whether compensation is excessive. It
will generally be helpful to have a detailed description of the duties of a disqualified person who is compensated by a foundation.

- Directors or trustees may receive compensation, but the level will generally be modest unless the office carries significant duties with it.

- The making of a cash advance to a foundation manager or employee for expenses incurred on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager. Except in the case of extraordinary expenses such as long distance travel, these advances should not exceed $500.

- Foundation managers may also be indemnified for liabilities arising out of their work for the foundation, subject to certain limits.

  (a). The foundation may indemnify a manager in any civil (as opposed to criminal) proceeding arising out of the manager’s work for the foundation if the expense is reasonable and the manager has not acted willfully and without reasonable cause.

  (b). Indemnification for the payment of penalty taxes under the private foundation rules will not be self-dealing only if the indemnity payments are treated as compensation and the compensation provided to the manager, as a whole, is not excessive. The same treatment applies to expenses of correcting self-dealing or other acts prohibited by the private foundation rules, unreasonable expenses incurred in a proceeding regarding liability, and expenses resulting from the manager’s acting willfully or without reasonable cause. The premiums on insurance to cover the indemnity items that are treated as compensation will also be treated as compensation.

  (c). Many states require particular provisions in articles of incorporation if a corporate charity is to provide the maximum indemnification permitted by law. Older corporate documents may need to be changed in order to permit the greatest possible protection for officers and directors.

(d). In considering indemnification issues, foundations should also be aware of the Federal Volunteer Protection Act of 1997.

- This act generally protects those who perform services for a Code section 501(c)(3) organization and receive less than $500 per year in compensation from liability for acts within the scope of their duty other than crimes, gross negligence, reckless misconduct, or harm from operating a motor vehicle requiring a license.

- Although the federal act preempts state law, some state laws also contain protections for volunteers.

- In light of these provisions, would nominally compensated foundation personnel be better off serving for free? One important reason to answer “no” is that the legal protections do not provide for the payment of the costs of defending a claim. Although the federal act is not explicit, it appears that the cost of insurance would be treated as compensation for its purposes. If that cost is less than $500 per year and no other compensation is paid, the best of both worlds – insurance and protection under the federal act – can be available.

OTHER TRANSFER OR USE OF THE INCOME OR ASSETS OF A PRIVATE FOUNDATION

Any other use of the income or assets of a private foundation to benefit a disqualified person, even if not specifically covered in the preceding categories, is likely to be self-dealing. For example, the guarantee by a private foundation of a loan to a disqualified person will normally be self-dealing, as will the making of a grant or payment that satisfies a legal obligation of a disqualified person. However, it is appropriate for the private foundation to pay for its own reasonable start-up costs, including legal fees, even though these fees may be incurred at the request of the disqualified persons who set up the foundation.

PAYMENTS TO GOVERNMENT OFFICIALS

A payment to a government official by a private foundation generally constitutes self-dealing. However, an agreement to hire a government official who is leaving government service within 90 days is not self-dealing. There are other exceptions, of which the most important
are exclusions from self-dealing in case a government official receives some benefit (such as an award or scholarship) as a member of the general public, receives a token amount (less than $25), or participates in a conference sponsored by a private foundation.

The laws of many states provide procedures for corporate charities to approve transactions in which a corporate “insider” has an interest. The procedures typically include review of the transaction by the disinterested directors of the charity. It is important to note that this approval is a matter of state law and cannot override the self-dealing prohibitions in the federal tax law.

• As a result, the procedures for approving transactions with insiders are useful only to public charities or to private foundations for a transaction that falls into an exception from self-dealing.

• The procedures may, for example, be useful in setting the compensation of a disqualified person for reasonable and necessary personal services to the foundation. The procedures are generally consistent with the IRS conflict of interest policy provided as the Appendix to this document.
MANDATORY DISTRIBUTIONS

Each year, a private foundation must distribute at least a minimum amount of cash or property for charitable purposes.

Generally, this minimum amount is equal to 5 percent of the fair market value of the private foundation’s investment assets minus the amount of the private foundation’s investment income taxes.

- The assets subject to the 5 percent calculation are “noncharitable assets,” consisting largely of investments (cash, stocks, and bonds, for example). Assets excluded are:
  
  (a). Assets used in carrying out the foundation’s work, such as offices and office furniture
  
  (b). Program-related investments and functionally related businesses – meaning investments or business activities that further the foundation’s charitable purpose
  
  (c). Future interests, such as the remainder in a charitable remainder trust that is expected to pass to the foundation, or assets not yet received, such as unpaid pledges

- Investment assets are valued based on a 12-month average of their fair market value for the year at issue.

In order to meet this minimum payout, the private foundation must make “qualifying distributions.” There are two main types of qualifying distributions:

- Any amount paid to acquire an asset that will be used directly in carrying out an organization’s charitable purposes is a qualifying distribution.

Failure to meet the mandatory level of qualifying distributions by the end of a year following the year to which the distribution requirement relates will result in a tax equal to 30 percent of the undistributed amount. If the undistributed amount is not timely distributed after this initial tax has been imposed, an additional tax equal to 100 percent of the remaining undistributed amount will be imposed.

- Any amount paid to accomplish one or more charitable purposes is a qualifying distribution. This includes grants to other charitable organizations.

- However, amounts paid to an organization controlled by the private foundation and grants made to another private foundation are subject to a complex set of rules that generally require the amount to be regranted within a short period of time.

- Certain amounts “set aside” for particular charitable projects can also constitute qualifying distributions.

Failure to meet the mandatory level of qualifying distributions by the end of a year following the year to which the distribution requirement relates will result in a tax equal to 30 percent of the undistributed amount. If the undistributed amount is not timely distributed after this initial tax has been imposed, an additional tax equal to 100 percent of the remaining undistributed amount will be imposed.

- If an organization exceeds its minimum level of distributions, the excess can be carried forward to any of the five following years to reduce future required distributions.

- The one-year “grace period” for making qualifying distributions and the carryforward provide a fair amount of leeway in the timing of qualifying distributions. However, many foundations prefer to avoid complicating a calculation that is complex enough to begin with and meet the qualifying distribution amount on a year-by-year basis.
EASY DISTRIBUTIONS, HARDER DISTRIBUTIONS, AND TAXABLE EXPENDITURES

How you distribute, as well as how much, is regulated. A private foundation is prohibited from making certain types of expenditures, known as taxable expenditures, that are not considered to be in keeping with its charitable purpose. There are five basic categories of taxable expenditures. The following discussion provides an overview of these categories, but the details of each category are not described in their full complexity.

GRANTS TO ORGANIZATIONS

- The easiest grant, which is never a taxable expenditure with one new exception, is a grant to a public charity or an “exempt operating foundation.”

(a). An exempt operating foundation is an organization that, while not a public charity, has received substantial public support for at least 10 years; actively carries on charitable programs (as opposed to making grants to other charities); and is not governed by substantial contributors, persons with more than a 20 percent interest in an entity that is a substantial contributor, or their families.

(b). There are several ways to determine whether a particular organization is a public charity or exempt operating foundation.

(c). You can ask the organization for a copy of the letter it received from the IRS indicating its status (the organization’s “determination letter”).

(d). You can check IRS Publication 78, which lists organizations to which charitable deductions may be made. The IRS list of exempt organizations is available online at http://www.irs.gov/charities/article/0,,id=96136,00.html.

Care should be taken in relying on the IRS listings. Some charities are not listed because of clerical errors. A number of religious organizations are tax-exempt charities but not listed in Publication 78 because they do not need to apply for formal recognition of their status. Some organizations’ names are misspelled and may be difficult to find. Listings may inaccurately state the status of an organization.

THE NEW EXCEPTION: GRANTS TO “TYPE III” SUPPORTING ORGANIZATIONS THAT ARE NOT “FUNCTIONALLY INTEGRATED” ARE NOT QUALIFYING DISTRIBUTIONS AND ARE TAXABLE EXPENDITURES

- Some definitions:

(a). A supporting organization is an entity that has public charity status by virtue of supporting a public charity.

(b). A Type III supporting organization is a supporting organization with the loosest permissible connection with its supported public charity – the Type III organization has to be operated in connection with a public charity but not controlled by it.

(c). A functionally integrated Type III supporting organization is yet to be fully defined, but as an interim matter, in Notice 2006-109, the IRS has defined it as an organization established to perform functions or carry out purposes that, but for the existence of the supporting organization, the supported organization would normally be engaged in itself. Grantors may rely upon appropriate affidavits from grantees, or opinions of counsel, in determining whether a supporting organization is one to which a qualifying distribution may be made.

- What does this mean in practice?

(a). Ask each grantee if it is a supporting organization.

(b). If so, ask it for proof that it is Type I, Type II, or functionally integrated Type III.

(c). “Expenditure responsibility” – described on the next page – can keep a grant to a non-functionally integrated Type III supporting organization from being a taxable expenditure but will not make it a qualifying distribution.
More care must be taken in making grants to foreign organizations. Options for foreign grantmaking include:

(a). Grants to U.S. charities operating programs outside the U.S., including “friends of” organizations.

(b). Grants to international organizations recognized by executive order (such as the United Nations or the International Monetary Fund).

(c). Grants to foreign governments to be used exclusively for public purposes.

(d). Grants to foreign charities that are equivalent to U.S. public charities but have not had that status recognized by the IRS. This category requires the grantmaking foundation:
   • to determine that, in its “reasonable judgment,” the foreign organization is a charity described in Code section 501(c)(3), even though that status has not been recognized by the IRS; and
   • to determine whether to exercise expenditure responsibility, as described below, based on an opinion of legal counsel or an affidavit of the grantee organization.

It is possible to develop a form of affidavit that can be given to foreign charities to help in this process; having a form of this type is useful for foundations that regularly make foreign grants.

When grantmaking to foreign organizations, a private foundation should ensure that such recipients are not suspected terrorist organizations by checking the lists of Specially Designated Nationals and Blocked Persons administered by the U.S. Department of the Treasury Office of Foreign Assets Control and the U.S. Department of State. Grants to foreign organizations may also be subject to U.S. tax withholding or require documentation of a waiver of withholding.

Any amount granted by a private foundation to an organization that is not a public charity or an exempt operating foundation – including another private foundation – is potentially a taxable expenditure.

(a). to see that the grant is spent solely for the charitable purpose for which it was made

(b). to obtain full and complete reports from the grantee on how funds are spent

(c). to make full and detailed reports about the expenditures to the IRS as part of its Form 990-PF

If a foundation plans to make grants for which it will need to exercise expenditure responsibility, the required procedures should be in place before the grant is made.

(a). The regulations governing expenditure responsibility require the foundation to make a “limited inquiry” before making the grant to obtain reasonable assurance that the grantee will use the grant properly.

(b). The grant should be made under a written agreement committing the grantee to repay any portion of the grant not used for the stated purpose, to keep records and report on the use
of the grant funds to the foundation, and to use the grant solely for charitable purposes and not for political or lobbying purposes.

- Expenditure responsibility also applies in the case of “program related investments,” meaning any investment made not with the hope of investment return as a significant factor but rather to carry out the foundation’s exempt purposes.

  (a). For example, a foundation that seeks to revitalize a blighted urban area can make a program-related investment in a hotel in that area, according to one IRS ruling.

  (b). In the case of program-related investments, the grant agreement must require use of the invested funds for the stated purpose and to repay any portion that is not so used, with a recognition that there may be legal limits on distributions to equity holders. Accounting to the foundation in the manner typical for commercial investments is also required.

- Another issue is earmarked grants – those that a private foundation gives to charity with a condition that they be used for the benefit of a particular purpose or entity. In this case, the recipient charity – sometimes called a “fiscal agent” – is disregarded and the ultimate beneficiary is treated as the direct grantee. If the ultimate grantee is not a proper recipient, the fact that a public charity acted as fiscal agent is of no help to the foundation.

- Grants can, however, be made subject to conditions that do not prevent the donee from using the grant in furtherance of its exempt purposes. A grant may, for example, be made to a hospital for the specific support of its cancer care unit.

GRANTS TO INDIVIDUALS

Any amount provided by a private foundation as a grant to an individual for travel, study, or other similar purposes can be a taxable expenditure.

- In practice, many foundations provide travel grants or scholarships through an important exception for grants awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the IRS.

- It is possible to have the procedure for awarding grants to individuals approved at the time the foundation applies for recognition of its tax-exempt status. It may also be submitted separately. In any case, tax or legal counsel who are experienced in this area can provide a procedure that will be acceptable to the IRS.

- Grants to individuals for purposes other than travel and study – for example, literary awards or grants to help the poor buy necessities of life – are not subject to the procedure requirements. IRS rulings in this area have considered as an important factor whether the grant is conditioned on future activities of the grantee.

- Even if a grant to an individual is not a taxable expenditure, it will be self-dealing if the recipient is a disqualified person with respect to the foundation.

EXPENDITURES FOR NON-CHARITABLE PURPOSES

In the maze of grantmaking and taxable expenditure issues, it is important not to lose sight of the fact that all amounts must be used for charitable purposes. Any amount paid or incurred by a private foundation for a non-charitable purpose is a taxable expenditure, regardless of the degree of control retained over the funds by the foundation.

INFLUENCING LEGISLATION

- Any amount paid or incurred by a private foundation to attempt to influence legislation is a taxable expenditure. Influencing legislation might occur either through direct lobbying or through grassroots lobbying.

- Direct lobbying is any attempt to influence legislation by communications with a member or employee of a legislative body or with any other government official who may participate in the formation of legislation.

- Grassroots lobbying is any attempt to influence legislation by affecting the opinion of the general public.

- For purposes of these rules, “legislation” includes action by Congress; action by any state legislature, local council, or similar body; or action by the public in a referendum, ballot initiative, constitutional
amendment, or similar procedure. Legislation also includes action by a foreign government.

• Certain narrow types of lobbying activity are not considered taxable expenditures:

(a). Providing technical advice to a governmental body at its written request

(b). Making available the result of nonpartisan analysis, study, or research

(c). Lobbying with respect to a decision that might affect the existence of the private foundation (so-called self-defense lobbying)

(d). Examinations of broad social, economic, and similar problems

These exceptions are narrowly defined and the subject of detailed rules. A private foundation should always consult with legal counsel before engaging in any activity that might be considered lobbying.

INFLUENCING ELECTIONS AND CARRYING ON VOTER REGISTRATION DRIVES

Any amount paid by a private foundation to influence the outcome of any public election is a taxable expenditure. Likewise, any amount paid or incurred to carry on a voter registration drive is a taxable expenditure. In addition to being taxable expenditures, election activities such as these can cause the private foundation to lose its tax-exempt status. As in the case of lobbying activities, the rules in this area can be complicated. A private foundation should always consult with legal counsel before engaging in any voter registration drive or in any activity that will influence the outcome of a public election. As a general rule, these activities should be avoided.

PENALTIES FOR TAXABLE EXPENDITURES

A tax of 20 percent of the amount of each taxable expenditure is imposed on the private foundation, and a tax of 5 percent (limited to $10,000) is imposed on any foundation manager who knowingly agreed to any taxable expenditures. If the taxable expenditures are not timely corrected, an additional tax of 100 percent is imposed on the private foundation. In the same circumstances, an additional tax of 50 percent (limited to $20,000) is imposed on the foundation manager.
EXCESS BUSINESS HOLDINGS

A private foundation may own only a limited amount of any particular business enterprise.

• Generally, a private foundation is permitted to hold 20 percent of the voting stock of a corporation less the percentage of the voting stock owned by all disqualified persons.

• If together a private foundation and all disqualified persons do not own more than 35 percent of the voting stock of a corporation, and non-disqualified persons effectively control the corporation, then the private foundation may hold 35 percent of the voting stock less the percentage of voting stock owned by all disqualified persons.

• A private foundation can always hold up to 2 percent of the voting stock of the corporation (provided it owns 2 percent or less in value of all outstanding shares of all classes of stock), regardless of the amount of stock owned by all disqualified persons.

• Any amount of stock above these permitted amounts is considered an excess business holding. Similar requirements apply to holdings in partnerships and other unincorporated business enterprises.

• As always, there are exceptions. The following are not considered businesses for purposes of the excess business holding rules:

  (a). A company that receives 95 percent or more of its gross income from passive sources is not subject to the excess business holding rules. This exception protects a foundation that in effect holds a piece of its endowment in a separate investment company.

  (b). A “functionally related business” – one that is actively related to the organization’s exempt purposes. For example, the IRS has ruled that a foundation that is devoted to promoting musical education and philanthropy and to popularizing the study of music can own 80 percent of the stock of a publisher of serious music without violating the excess business holding rules.

  (c). A program-related investment, as defined on page 14 in the discussion of expenditure responsibility.

• A private foundation that has excess business holdings owes a tax of 10 percent of its value. If the private foundation does not timely dispose of its excess business holdings, an additional tax equal to 200 percent will be imposed. Timely disposition means divesting the excess business holding within five years, with the possibility of an extension for another five years if divestment has proven difficult despite diligent efforts by the foundation.
JEOPARDIZING INVESTMENTS

A private foundation cannot invest its funds in a manner that would jeopardize its charitable purpose.

- No category of investments is treated as a per se violation of these rules. Instead, an investment will be considered to jeopardize the charitable purpose of the private foundation if the private foundation’s managers fail to exercise ordinary business care and prudence in making the investment. In the exercise of the requisite standard of care and prudence, the foundation managers may take into account the expected return, the risks of rising and falling price levels, and the need for diversification of the investment portfolio.

- Certain types of investment will be closely scrutinized by the IRS in determining whether the foundation managers have met the requisite standard of care and prudence. These include:
  
  (a). trading in securities on margin;
  
  (b). trading in commodity futures;
  
  (c). investments in working interests in oil and gas wells;
  
  (d). the purchase of puts, calls, and straddles;
  
  (e). the purchase of warrants; and
  
  (f). short sales.

- These “suspicious categories” reflect thinking that is being discarded under the laws of most states.

  (a). In particular, foundations in trust form are now subject, in the majority of states, to some version of the Uniform Prudent Investor Act; in some states the act applies to corporate charities, and even where it doesn’t, the standards of prudent investment set out in the act are often influential in evaluating a corporate charity’s asset management decisions. The act adopts the principles of modern portfolio theory for trust investments: no category of investment is imprudent and investments are not considered in isolation; the focus is on whether the portfolio as a whole is designed with appropriate risk and return objectives in mind; a duty to diversify investments is imposed absent special circumstances.

(b). It should generally be possible to design a portfolio that meets the requirements of prudent investment under modern portfolio theory while avoiding the categories considered suspicious by the IRS.

(c). However, the IRS has issued a number of private letter rulings – again, not precedent, but helpful indications of current thinking – approving what might broadly be termed “alternative” investments, including:

- **PLR 200318069** (hedge fund)

- **PLR (also Technical Advice Memorandum) 200218038** (limited partnership that trades in commodity futures and forward markets)

- **PLR 9723045** (investment of less than 30 percent of the foundation’s total assets in six different “alternative investment” funds, including high-technology partnerships and companies; hedge funds; the securities of companies being restructured or reorganized; commercial forests; and leveraged acquisitions)

- **PLR 9237035** (investment of 10 percent of a foundation’s assets in a managed commodities trading fund)

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*It should generally be possible to design a portfolio that meets the requirements of prudent investment under modern portfolio theory while avoiding the categories considered suspicious by the IRS.*
(d). By contrast, in PLR 9205001, the IRS ruled that jeopardizing investments were made when all of the foundation’s assets were in a single closely held company, the risk of investing in that industry was not considered, there was no reasonable expectation of a return, and the investments were not diversified; and in Technical Advice Memorandum 9627001, the IRS determined that the placement of all of a private foundation’s assets in a margin account to collateralize a disqualified person’s investments in futures contracts constituted a jeopardizing investment.

(e). Debt-financed income of the type generated by many of the investment vehicles considered above could be subject to income tax, notwithstanding the tax-exempt nature of a foundation, because of rules for “unrelated business taxable income” and “unrelated debt-financed income.” Commonly, however, the exposure to the tax is managed by having nonprofits participate in the investment through separate entities such as offshore corporations.

- In addition, no purpose of an investment may be the furthering of substantial legislative or political activities.

- A program-related investment, the primary purpose of which is to accomplish one or more charitable purposes, and no significant purpose of which is the production of income or the appreciation of property, will not be a jeopardizing investment.

- A private foundation is subject to a tax of 10 percent on each jeopardizing investment. Any foundation manager who participates in the making of an investment knowing that it is a jeopardizing investment will also be subject to a tax of 10 percent (up to $10,000 for each jeopardizing investment) of the amount invested. If the investment is not timely removed from jeopardy, the foundation will be subject to an additional 25 percent tax. Any foundation manager who refuses to agree to remove an investment from jeopardy will be subject to an additional 5 percent tax (up to $20,000 for each jeopardizing investment).
INVESTMENT INCOME TAX

A private foundation is subject to an annual excise tax of 2 percent of its net investment income. This tax must be reported on the private foundation’s annual return, Form 990-PF. If the private foundation expects that its tax for the year will be $500 or more, the private foundation must make periodic deposits of estimated tax payments.

- Estimated tax payments are due on the fifteenth day of the fifth, sixth, ninth, and twelfth months of the private foundation’s fiscal year (May, June, September, and December for a private foundation using a calendar year). Estimated tax payments are generally required to be made using the Electronic Federal Tax Payment System (“EFTPS”).

- Net investment income includes income from interest, dividends, rents, payments with respect to securities loans, and royalties received by a private foundation from all sources, including investment income from assets dedicated to charitable purposes.

- Net investment income also includes net capital gains from the disposition of property used for the production of income subject to the investment income tax. Gains or losses from the disposition of assets used to accomplish the foundation’s exempt purpose are excluded in determining capital gain net income. Capital losses can be used only to offset capital gains. If the private foundation experiences a capital loss for the year, such loss will not reduce the amount of the private foundation’s other investment income. These unused capital losses are lost; they cannot be carried forward or carried back to other tax years.

- In computing net investment income, the private foundation can deduct the ordinary and necessary expenses that relate to the production of the investment income. A private foundation must allocate its operating expenses between those expenses attributable to investment activity and those attributable to its charitable activities. Investment income taxes are not deductible.

- A private foundation can reduce its investment income tax rate to 1 percent by increasing the amount of its qualifying distributions by 1 percent of the foundation’s net investment income.

A private foundation can reduce its investment income tax rate to 1 percent by increasing the amount of its qualifying distributions by 1 percent of the foundation’s net investment income.
FEDERAL TAX RETURN FILING AND PUBLICITY REQUIREMENTS

Every year, a private foundation must file an information return with the IRS. This return is filed on Form 990-PF and is due on the fifteenth day of the fifth month of the private foundation’s fiscal year (May 15 for private foundations using a calendar year). A private foundation must also send a copy of its annual return to the attorneys general of the states in which it is formed or operates.

• Other publicity requirements:

  (a). A private foundation’s annual information returns must be made available for public inspection and copying for three years.

  • Required to be disclosed are an exact copy of the foundation’s Form 990-PF, any Form 4720 filed by the private foundation, all schedules and attachments to either, and any amended returns. Each of those returns is subject to disclosure for three years from the later of its due date (including extensions) or the date actually filed. An amended return is subject to disclosure for three years from the date of its filing.

  • A private foundation’s exemption application subject to disclosure includes the Form 1023 (Application for Recognition of Exemption) filed by it, any statement or other document submitted in support of the exemption application whether filed with the application or thereafter, and any letter or other document issued by the Internal Revenue Service, such as a list of questions about the application or a favorable determination letter. An exemption application is not subject to disclosure while it is still pending before the Internal Revenue Service. An exemption application filed before July 15, 1987, is not subject to disclosure if the organization did not have a copy of the application on that date.

  (b). Private foundations used to be required to publish notice of the availability of their annual information returns for public inspection. This requirement no longer applies at the federal level, but some states may still require it.

• There are detailed rules for public inspection and the provision of copies, including the amounts a foundation may charge. However, because charities’ returns are readily available on the Internet, few charities receive in-person or mail requests for inspection or copies of documents. If you do receive such a request, please contact us.

A private foundation’s annual information returns must be made available for public inspection and copying for three years.
APPENDIX:
IRS SAMPLE CONFLICT OF INTEREST POLICY

Note: Items marked Hospital Insert – for hospitals that complete Schedule C are intended to be adopted by hospitals.

ARTICLE I - PURPOSE

The purpose of this conflict of interest policy is to protect this tax-exempt organization’s (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction. This policy is intended to supplement but not replace any applicable state and federal laws governing conflict of interest applicable to nonprofit and charitable organizations.

ARTICLE II - DEFINITIONS

1. Interested Person
Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.

[Hospital Insert – for hospitals that complete Schedule C
If a person is an interested person with respect to any entity in the health care system of which the organization is a part, he or she is an interested person with respect to all entities in the health care system.]

2. Financial Interest
A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:

(a). an ownership or investment interest in any entity with which the Organization has a transaction or arrangement,

(b). a compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or

(c). a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial. A financial interest is not necessarily a conflict of interest.

Under Article III, Section 2 of this policy, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

ARTICLE III - PROCEDURES

1. Duty to Disclose
In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists
After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

(a). An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.

(b). The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

(c). After exercising due diligence, the governing board or committee shall determine whether the Organization can obtain with reasonable efforts a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.

(d). If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Organization’s best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination it shall make its decision as to whether to enter into the transaction or arrangement.
4. Violations of the Conflict of Interest Policy

(a). If the governing board or committee has reasonable cause to believe a member has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

(b). If, after hearing the member’s response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

ARTICLE IV - RECORDS OF PROCEEDING

The minutes of the governing board and all committees with board delegated powers shall contain:

(a). The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board’s or committee’s decision as to whether a conflict of interest in fact existed.

(b). The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

ARTICLE V - COMPENSATION

(a). A voting member of the governing board who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member’s compensation.

(b). A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member’s compensation.

(c). No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

(d). [Hospital Insert – for hospitals that complete Schedule C
Physicians who received compensation from the Organization, whether directly or indirectly or as employees or independent contractors, are precluded from membership on any committee whose jurisdiction includes compensation matters. No physician, either individually or collectively, is prohibited from providing information to any committee regarding physical compensation.]

ARTICLE VI - ANNUAL STATEMENTS

Each director, principal officer and member of a committee with governing board delegated powers shall annually sign a statement which affirms such person:

(a). has received a copy of the conflicts of interest policy,

(b). has read and understands the policy,

(c). has agreed to comply with the policy, and

(d). understands the Organization is charitable and in order to maintain its federal tax exemption it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

ARTICLE VII - PERIODIC REVIEWS

To ensure the Organization operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

(a). Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm’s length bargaining.

(b). Whether partnerships, joint ventures, and arrangements with management organizations conform to the Organization’s written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes and do not result in inurement, impermissible private benefit or in an excess benefit transaction.

ARTICLE VIII - USE OF OUTSIDE EXPERTS

When conducting the periodic reviews as provided for in Article VII, the Organization may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.