Primer on Private Foundations
Reference Outline

Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Amanda Adams
Blazek & Vetterling
Houston, Texas

Author contact information:
Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, TX
dmoore@bwwlaw.com
817-877-1088

Amanda Adams
Blazek & Vetterling
Houston, TX
amanda.adams@bvcpa.com
713-439-5741
# PRIMER ON PRIVATE FOUNDATIONS

## TABLE OF CONTENTS

I. INTRODUCTION 1  
II. FORMATION OF PRIVATE FOUNDATIONS 1  
   A. Choosing the Best Form of Organization 1  
   B. Choosing Classification as a Private Foundation or a Public Charity 3  
   C. Types of Public Charities 5  
   D. Types of Private Foundations 5  
   E. Tax Treatment of Contributions to Private Non-Operating Foundations 6  
III. FILING PROCEDURES FOR IRC §501(C)(3) ORGANIZATIONS 7  
   A. Application for Recognition of Exempt Status 7  
   B. Local Applications 9  
   C. Registration with Charities Bureaus 9  
IV. RESTRICTIONS ON FOUNDATIONS 9  
   A. §4940 – Excise Tax on Net Investment Income 9  
   B. §4941 – Self-Dealing 10  
   C. §4942 – Undistributed Income 12  
   D. §4943 – Excess Business Holdings 14  
   E. §4944 – Jeopardizing Investments 15  
   F. §4945 – Taxable Expenditures 15  
V. QUALIFICATION AS A PRIVATE OPERATING FOUNDATION 20  
   A. Advantages 20  
   B. POF Tests 20  
VI. OPERATIONS AND ANNUAL FILINGS 22  
   A. Operations 22  
   B. Form 990-PF 27  
   C. Form 990-T 27  
   D. Form 4720 27  
   E. Forms Relating to Alternative Investments 27  
   F. State Reports 28  
   G. Employer Returns 28  
   H. Substantiation Documentation 28  
VII. TERMINATION OF PRIVATE FOUNDATION STATUS AND/OR EXISTENCE 29  
   A. Voluntary Termination 29  
   B. Involuntary Termination 29  
   C. Transfer of Assets to Certain Public Charities 29  
   D. Operating as a Public Charity 29  
   E. Transfer of Assets to One or More Private Foundations 30  
   F. Calculation of the Termination Tax 30  
   G. Final Filings with the IRS 31  
   H. State Termination 31
PRIMER ON PRIVATE FOUNDATIONS

I. INTRODUCTION

Private foundations were segregated by Congress in 1969 from public charities, those organizations that traditionally receive their contributions from a wide range of supporters, rather than from a limited set of individuals. Private foundations are viable and valuable types of nonprofit organizations, despite the fact that they must operate under constraints not applicable to public charities. A private foundation can serve as the ideal income and estate tax planning tool for taxpayers with charitable interests. This outline describes the major considerations in the planning, creation and operation of private foundations.

II. FORMATION OF PRIVATE FOUNDATIONS

A. Choosing the Best Form of Organization:

A charitable organization is established by the creation of a nonprofit entity under applicable state law. The three common structural forms for a nonprofit organization are nonprofit corporation, trust, and unincorporated association. The choice of organizational form is influenced by the laws of the states in which the nonprofit will operate. A charitable organization may be created during life or through testamentary disposition. If created testamentary, the Will should allow for the executor to create the charitable organization and should state that the charitable organization is created for charitable purposes to make distributions to qualified charities.

1. Corporation: A corporation is generally the preferred entity for the charitable organization as it provides the most flexibility of operation and protection from liability for the organization’s officers and directors. Their decisions in a corporation structure are evaluated on the business judgment rule as opposed to the more strict fiduciary standards applicable to trustees of trusts.

   a. Certificate of Formation must include:

      i. Federal Law Requirements:

         1. Purpose clause: The organization must limit its purposes to one or more of the eight specific purposes in §501(c)(3) which includes religious, charitable, scientific, testing for public safety, literary, educational, fostering national or international amateur sports competitions, and preventing cruelty to children or animals.

         2. Inurement clause: Qualifying organizational documents must not permit distribution of any part of the organization’s net earnings to its directors, officers, or trustees, or to any private individual. Most documents affirmatively include a statement that the earnings of the corporation shall not result in any private benefit to its members, trustees, or officers, other than for reasonable compensation for services rendered.
3. Political activities clause: A charity’s organizational documents must absolutely not permit political campaign involvement and so to be conservative should prohibit such activity. In addition, a private foundation is absolutely prohibited from conducting lobbying. The following statement covers both types of activities: “No part of the corporation’s activities shall consist of attempts to influence legislation and it shall not participate in political campaigns.”

4. Dissolution clause: Specific language in the nonprofit’s charter must describe the manner in which its assets will be distributed in the event of dissolution. Assets may not be returned to contributors, directors, or any non-501(c)(3) organization or for non-501(c)(3) purposes. It is not sufficient to say that the assets will be dedicated to nonprofit purposes since those purposes may be broader than what 501(c)(3) allows. Remaining assets at the time of dissolution must either be expended for 501(c)(3) purposes or be given to another 501(c)(3) organization, or the federal, state, or local government.

5. Private foundation clause: A statement that the corporation will comply with the requirements of I.R.C. §§ 4941 through 4945 is required for those organizations which were formed in states that have not enacted statutory provisions that satisfy this requirement automatically without the inclusion of specific language in the charter.

ii. State Law Requirements (Texas):

1. Entity name and type.
2. The street address of its initial registered office and the name of its initial registered agent at such street address.
3. Management structure (i.e. The number of directors constituting the initial board of directors, (must be at least three (3)) and the names and addresses of the persons who are to serve as the initial directors unless the management of the corporation is vested in its members, in which case, a statement to such effect must be included.).
4. The purpose(s) for which the organization is organized.
5. A statement that the organization is to have no members if such is the case.
6. The name and street or post office address of each organizer, of which only one is required.
7. A statement describing the manner of distribution of the corporation’s assets if the organization is to be authorized on its dissolution to distribute its assets in a manner other than as provided by State law.
8. Any other provision not inconsistent with law.
b. Bylaws: The organization’s bylaws govern the operation of the organization. They should include provisions governing:

i. The Board of Directors, including terms, election, meetings, manner of acting and notices.
ii. If the organization has members, requirements for membership, term of membership and powers of the members.
iii. Officers, including election, duties and compensation.
iv. Creation of committees, their duration and operation and management of committee meetings.
v. Capacity of the organization to enter into contracts.
vi. Establishment of the organization’s tax or fiscal year.

2. Trust: The trust form of organization is often chosen for an individually or family-funded charitable organization. A trust created while one is living is called an inter vivos trust. A trust created by a bequest in the creator(s)’ will is called a testamentary trust. A trust is favored by some because, unlike a corporation, a trust can be totally inflexible absent a reformation approved by a court order. A trust can be created without provisions allowing for changes in its purpose or trustees. Thus, a donor with specific wishes may prefer this potentially unalterable form for a substantial testamentary bequest. Another advantage of a trust is that some states do not require registration of a charitable trust. Exempt organization immunity statutes do not apply to trusts in some states, and more stringent fiduciary standards are often imposed upon trustees than on corporate directors.

3. Unincorporated Association: This form of nonprofit organization is the easiest to establish and correspondingly, to reform. To qualify for exemption, an association must have organizing instruments outlining the same basic information found in a corporate charter or trust instrument. Rules of governance must be provided and it must have regularly chosen officers. IRS procedures require that the constitution, or articles of association, be signed by at least two persons. An unincorporated group may face substantial pitfalls. The primary concern is the lack of protection from legal liability for officers and directors. Banks and creditors may be reluctant to establish business relationships without personal guarantees from the officers and directors.

4. Limited Liability Companies: An LLC electing to be treated as a corporation (as opposed to a partnership or disregarded entity) is another form of nonprofit organization. An LLC is only eligible for exempt status under §501(c)(3) if its member(s) are §501(c)(3) organizations.

B. Choosing Classification as a Private Foundation or a Public Charity:

Private foundations must comply with a variety of special rules and sanctions. The allowable contribution deductions for gifts to private foundations are less than those afforded to public charities. It is useful for a charitable organization, when possible, to obtain and maintain public status. However, if a donor desires to have control of the organization’s distributions and is not
concerned about the reduced income tax percentage deduction limitations applicable to private foundations, the donor should consider classification as a private foundation. If an organization intends to have many sources of funding and have fundraising activities, it should consider classification as a public charity. If the organization intends to support a limited number of existing public charities, it should consider classification as a supporting organization. If a donor does not want the administrative burden of operating a private foundation, but would rather recommend grants from an endowment the donor has funded, the donor should consider creating a donor advised fund through a community foundation.

1. Advantages of a Private Foundation: Establishing and funding a private foundation allows the donor to feel satisfied that he or she is returning something to society. It provides more control to the donor than does a donation to a community foundation or supporting organization because the donor has the right to distribute the foundation assets to organizations (public charities) he or she prefers and he or she can stay in control of the foundation’s investments. Thus, the foundation often makes the donations for the family. Additionally, the family can stay in control over time by specially drafting into the organizational documents that family members are to serve on the board of directors. It also gives the younger family members an opportunity to participate in a meaningful endeavor and become familiar with the charitable goals, intentions and business and management philosophies of the foundation creator. If the foundation employs family members, compensation must be reasonable under I.R.C. § 4941. This should be contrasted with the prohibition arising from the Pension Protection Act of 2006 on payment of any compensation to substantial contributors or their family members by supporting organizations. Additionally, the private foundation is not beholden to public memberships, nor is it required to continuously raise funds. Further it enables the donor to evaluate grant seekers’ proposals against the charitable goals of the foundation without being bombarded by the charities and provides anonymity in giving. It also is a vehicle which allows for contributions to foreign organizations.

2. Disadvantages of a Private Foundation: One disadvantage of the private foundation is the application of the excise tax system, including annual excise tax of 2% on net investment income, which prevents the private foundation from abusing the greater flexibility and control that it has. Another disadvantage is that the deduction for income tax charitable contributions is more limited than a contribution made to public charities or supporting organizations. Additionally, since the costs of reporting, hiring professional advisors (legal, tax reporting and investment, etc.) and the reporting requirements of the foundation are significant, it is not generally considered cost effective in the mind of many legal advisors to create such a private foundation unless the donor has significant charitable inclinations and the funding is expected to be $1,000,000 or more (though some institutions are providing administrative services to encourage smaller foundations). Most important of all, if the donor is a control and investment “maverick”, then the private foundation may prove problematic because of the applicable stringent rules and reporting requirements.
C. Types of Public Charities:

1. Organizations that are, by definition or by activity, public charities I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i), (ii), (iii), and (v) (“traditional” public charities including churches, schools, hospitals and medical research organizations, and governmental units);

2. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(iv) and (vi) (“publicly supported charities”);

3. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) (“gross receipts” or “service provider” publicly supported charities);

4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3) (Supporting Organizations). A supporting organization is really only indirectly public, meaning that the public that monitors this organization’s operations does so through an intervening public charity. That intervening public charity is the entity to which the supporting organization must answer regarding organization and operation. Because of its “public charity” nature, its attractiveness to potential donors is enhanced because donations are allowed the more favorable tax deduction limitation of those made to public charity. However, a donor seeking control is not as likely to favor this organization as the choice for his or her donation because the organization cannot be controlled by the donor, the donor’s family or other “disqualified persons” defined later in this outline.;

5. Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4) (beyond the scope of this outline).

An I.R.C. §501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above.

D. Types of Private Foundations:

1. Private Nonoperating Foundation: The most common type of private foundation is the nonoperating foundation. It does not directly perform any charitable programs or services. It generally receives its funding from one primary source, such as an individual, a family or a corporation. It does not generally actively raise funds or seek grants. It is required to distribute approximately 5% of its assets annually to public charities. Donors’ charitable income tax deductions are more limited than when made to a public charity.

2. Private Operating Foundation: The operating foundation has a stated charitable purpose and carries out its own programs. It conducts charitable activities directly rather than awarding grants to other charitable organizations, although it can do both. The operating foundation must expend substantially all of its adjusted net income directly for the
purposes of its own charitable activities. Although donors receive the more liberal public charity income tax deduction limitations, this type of foundation remains subject to the private foundation restrictions because its source of funding is generally from one individual, family or corporation.

3. Exempt Operating Foundation: This category of foundation customarily applies to museums, libraries, and other quasi-public charities that meet very specific requirements. They are not required to pay the excise tax on investment income. This type of foundation is beyond the scope of this outline.

4. Conduit Foundation: A private foundation becomes a conduit foundation during a year in which it makes qualifying distributions that are treated as distributions out of corpus in an amount equal to 100 percent of the contributions it receives during the year (see below). A conduit foundation is sometimes referred to as a “passthrough” foundation because it receives, but does not keep, and instead redistributes, donations to allow its donor(s) to receive a higher deduction limitation for contributions to the foundation. The status as a conduit foundation applies on a year-by-year basis.

E. Tax Treatment by Donors of Contributions to Private Non-Operating Foundations:

1. Gifts of Cash and Non-Appreciated Property: Income tax deduction is limited to an amount equal to thirty percent (30%) of the donor’s adjusted gross income in the taxable year (as opposed to 50% for gifts of cash and other non-appreciated property to public charities and to operating foundations). Any excess can be carried forward for the next five years. However, the deduction may be zero if the donor has contributed capital gain property to public charities in excess of the 30% deduction limitation. Corporate contributions are limited to 10% of taxable income with a five year carry forward of excess contributions. See IRC § 170(b)(2) and § 170(d)(2)(A).

2. Gifts of Appreciated Property: Income tax deduction is limited to twenty percent (20%) of donor’s adjusted gross income on gifts of appreciated property (as opposed to 30% for gifts of appreciated property to public charity.) Additionally, gifts of appreciated assets are limited to a deduction of only the donor’s basis in the asset, unless the asset is publicly traded stock which has been held more than one year by the donor. Any excess can be carried forward for the next five years.

3. Deduction for gifts to certain Private Foundations - Pass Through Foundations: If a foundation meets the criteria of I.R.C. §170(b)(1)(A)(vii) and §170(b)(1)(F)(ii), the donor may receive a deduction as if the gift was made to a public charity (i.e. limited to 50% of the donor’s adjusted gross income for gifts of cash and other non-appreciated property and 30% of the donor’s adjusted gross income for gifts of appreciated property to a public charity). Pass through foundations are described as any other foundation (as defined in section 509(a)), which makes qualifying distributions in an amount equal to 100% of the foundation’s contributions for the year, before the 15th day of the third month following the close of the foundation’s taxable year. To substantiate the deduction, the taxpayer must obtain adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions. I.R.C. §
170(b)(1)(A)(vii) and §170(b)(1)(F)(ii). These types of distributions may be attractive to a founder who would be willing to make the required distributions from the foundation during his or her life in order to receive the 50% deduction, further funding the foundation with an endowment at his or her death.

4. Itemized Deduction Limitation: §68 provides an overall limitation on a taxpayer’s itemized deductions if the taxpayer’s adjusted gross income (AGI) exceeds a certain amount. This limitation was phased out so that it did not apply during 2010, 2011, or 2012. However, absent new legislation, the limitation will come back for 2013. Thus, if a taxpayer’s AGI exceeds an “applicable amount,” the overall itemized deduction (including charitable contributions will be reduced. The amount of the reduction is the lesser of (1) 3% of the excess of AGI over the applicable amount, or (2) 80 percent of the amount of the itemized deductions otherwise allowable. Certain itemized deductions will not be limited by this rule, including medical expenses, investment interest, and personal casualty or theft losses.

III. FILING PROCEDURES FOR IRC §501(C)(3) ORGANIZATIONS

A. Application for Recognition of Exempt Status:

I.R.C. § 508(a)(1) provides that an organization organized after October 9, 1969, generally will not be treated as exempt under I.R.C. § 501(c)(3) until it notifies the Internal Revenue Service that it seeks recognition of exemption under that section. If the required notice is filed late, the exempt status, if granted, will not be retroactive and will not apply to any period prior to the date of such filing.

1. Form of Notice: The proper Notice is provided on Form 1023 – Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code.

2. Time of and Place for Filing Notice: The Form 1023 must be filed with the Ohio District Office (Covington, Kentucky) within 27 months from the end of the month of its organization, which is the date it becomes an organization described in I.R.C. § 501(c)(3). Treas. Regs. § 1.508-1(a)(2)(i), (iii). If the organization fails to file Form 1023 or files late, it will not be treated as exempt for any period prior to the filing of the notice. Treas. Regs. § 1.508-1(a)(1)(i); Rev. Rul. 77-207, 1977-1 C.B. 152. A substantially completed filing begins the running of the 270-day period in which the key District Director must rule on the application. (See discussion below as to “substantially complete” Form 1023.)

a. Incomplete Submission: If an organization submits an incomplete Form 1023 within the required time period for filing, and files such additional information as the Internal Service may request within the additional time period set by the Internal Revenue Service, even though beyond the 27-month filing deadline, the organization is deemed to have met the requirements of I.R.C. § 508(a). Treas. Regs. § 1.508-1(a)(2)(ii).
b. Requirement to Make Substantial Changes to Articles: If the organization is required to alter its activities or to make substantial amendments to its articles of organization, the ruling or determination letter recognizing exemption will be effective as of the date of the change.

c. Nonsubstantive Changes: If non-substantive amendments are required to be made to the articles of organization, the exemption is normally recognized retroactively to the date of formation. Rev. Proc. 90-27, 1990-1 C.B. 514.

d. District Director’s Failure to Rule Within 270 day period: If a ruling is not issued by the key District Director within the 270 day period, the organization can seek a declaratory judgment.

e. Substantially Complete Form 1023: A substantially complete Form 1023 contains the following:

1) The signature of an authorized individual;
2) The organization’s employer identification number;
3) Statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization’s existence, if less than four years). [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and proposed budgets for the two succeeding accounting periods are sufficient.]
4) Statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures.
5) A copy of the Articles of Organization, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original. Any articles of organization must indicate compliance with any applicable local recording statute.
6) If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;
7) User fee payment for determination letter request: a check made payable to the United States Department of Treasury in payment of the user fee applicable to the organization. Rev. Proc. 93-23, 1193-1 C.B. 538, § 6.12 sets the user fee at $850.00 for initial applications for exempt status for organizations seeking exemption under I.R.C. § 501(c) whose actual or anticipated annual gross receipts exceed $10,000. Applications for exempt status (other than pension and profit sharing plans) that have had annual gross receipts averaging not more than $10,000 during the preceding four years, or new organizations anticipating gross receipt averaging not more than $10,000 during their first four years must pay a
user fee of $350.00. If the organization does not include the correct user fee with the application, the application will be returned.

The Internal Revenue Service often requests additional information from the organization seeking exempt status. An organization must timely and completely furnish any additional information requested or subject itself to dismissal of its petition for declaratory relief for failure to exhaust its administrative remedies. Rev. Proc. 90-27, 1990-1 C.B. 514.

B. Local Applications:
Application should also be made to state and local taxing authorities for exemption from franchise taxes, real and personal property taxes, rent taxes and sales taxes. Application should be made to the Texas Comptroller of Public Accounts for exemption from the Texas franchise tax based on the foundation’s status as a I.R.C. §501(c)(3) organization. The application is available on the Comptroller’s website (http://www.window.state.tx.us/).

C. Registration With Charities Bureaus:
Registration with the charities bureaus of the Attorney General’s Office (or other State Department) where applicable. No such registration is required in Texas.

IV. RESTRICTIONS UPON FOUNDATIONS

A. Excise Tax on Investment Income (I.R.C. § 4940): A private foundation must pay an annual excise tax equal to 2% of the foundation’s “net investment income.” The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor’s death. The ordinary and necessary expenses paid or incurred for the production and collection of such income include: brokerage fees, investment management fees and director fees applicable to managing the investments. If the tax for the year exceeds $500, it must be paid on a quarterly estimated basis.

1. Penalties: Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

2. Reduction of Excise Tax From 2% to 1%: The excise tax may be reduced from 2% to 1% provided that the foundation meets a “maintenance of effort” test. To meet such test, the foundation’s total qualifying distributions that are paid out during the tax year must equal or exceed the sum of the following two calculations:

   a. 5 Year Average Payout Times Current Year Assets: The foundation must calculate what its average payout percentage has been over the 5 years immediately preceding the year for which the return is being filed. If the foundation has been in existence for less than 5 years, then the calculation is based upon the number of years the foundation has been in existence. A newly organized foundation is not allowed the reduction in its first year of existence. The payout percentage is the amount of qualifying distributions for the
year divided by the amount of noncharitable use assets for the year. In short, the percentage is determined by dividing the dollar value of the endowment into the amount of dollars that qualified in meeting the payout for that year. After the 5 year average payout is determined, this percentage is multiplied by the value of the net noncharitable use assets (or endowment) for the tax year for which the return is being filed, plus:

b. Tax Savings or 1% of Net Investment Income: After a final figure is calculated for the 5 year average payout described above, it must be added to 1% of the net investment income.

c. In summary, the foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

3. Application in Estate Administration: Under Treas. Reg. § 53.4940-1(d)(2), a distribution from an estate does not retain its character for purposes of I.R.C. § 4940 when received by the distributee foundation. Thus, investment income earned by an estate will be treated as a contribution when received by the foundation beneficiary. See Rev. Rul. 80-118, 1980-1 C.B. 254, which provides that interest income on a bond not reported by an estate is taxable to the private foundation under I.R.C. § 4940.

B. Self-Dealing (I.R.C. § 4941): Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain Disqualified Persons of the foundation.

1. I.R.C. §4946 defines the term “Disqualified Person.” A Disqualified Person, with respect to a private foundation, is:

   a. A substantial contributor to the foundation. Substantial contributor is defined in I.R.C. §507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution.
   b. A foundation manager of the foundation. Foundation manager is defined as 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.
   c. Persons owning more than 20% of an entity which is a substantial contributor to the foundation.
   d. A family member (spouse, ancestors, descendants and spouses of descendants) of persons listed in a-c above.
   e. A corporation in which persons described in a-d above own more than 35% of the total combined voting power.
   f. A partnership in which persons described in a-d above own more than 35% of the profit interests,
2. Self-dealing includes any direct or indirect: a) sale or exchange or leasing of property between the private foundation and a Disqualified Person; b) lending of money or extension of credit between a private foundation and a Disqualified Person; c) furnishing of goods, services, or facilities between a private foundation and a Disqualified Person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the Disqualified Person, Treas. Reg. § 53.4941(d)(3)(b)(1); d) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a Disqualified Person, unless compensation is payment for personal services, is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1); e) transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation; and, f) agreement by a private foundation to make any payment of money or other property to a government official [as defined in I.R.C. § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. I.R.C. § 4941(d).

3. Reimbursement for Expenses: Reimbursement to a director (Disqualified Person) for travel expenses may cause the foundation and the director (i.e. a foundation manager) to be potentially liable for penalty taxes for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person.) Such reimbursement of expenses is permitted if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is “reasonable and necessary.” Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. § 1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is “excessive.” Under Treas. Reg. § 1.162-7, an amount spent on director’s services will not be deemed “excessive” if it is only such as would be paid “for like services by like enterprises under like circumstances.” Treas. Reg. § 1.162-7 (i.e. as the organization would pay to someone independent of the foundation). Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. § 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to cause an act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

4. Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected. Additionally, a foundation manager who willingly participates in the act
knowing it is prohibited is subject to a tax of 5% of the amount involved (not to exceed $20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected and the 10% was initially assessed and timely paid, the Disqualified Person is subject to being assessed an additional tax of 200% of the amount involved. Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to $20,000 for each such act.) If more than one foundation manager is liable under this section, such persons are jointly and severally liable.

C. Minimum Distribution Requirements (I.R.C. § 4942): A private foundation must generally distribute approximately 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation, such as cash, stocks, bonds and other investment assets. This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

1. Time Period for Distribution: A foundation has until the end of the next tax year to satisfy the minimum payout requirement for that taxable year. Generally this is 12 months but if the foundation changes its year end in the succeeding year it could be less than 12 months.

2. Qualifying Distributions: Generally, a private foundation’s Qualifying Distributions will consist of grants to qualified charitable organizations (I.R.C. § 501(c)(3) public charities). (Private foundations may no longer count grants or payments to supporting organizations classified as Type III-Other or that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.) Qualifying distributions also include grants to non-charities for “charitable purposes,” costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

   a. Administration Expenses: Administration expenses do not include investment expenses incurred in managing the endowment. Accordingly, investment management fees, brokerage fees, custodial fees, salaries, or board meeting expenses to oversee investments do not count toward meeting the minimum payout requirement. All other administration expenses that are necessary and reasonable can be taken into consideration. Administration expenses that do count toward the payout include salaries, benefits, trustees’ fees, professional fees, travel expenses, general overhead, training, publications, office supplies, telephone, rent, preparation of tax returns, defending legal matters, obtaining rulings from the Service, state and federal filing requirements, costs to purchase newspaper ad announcements of the availability of the tax return for public inspection, cost of annual report and year-end audit. Furthermore, unreasonable expenditures for administrative expenses, including compensation and consultant fees will be taxable expenditures unless the foundation can prove that the expenses were paid or incurred in the good faith belief that they
were reasonable and that the payment or incurrence of such expenses was consistent with ordinary business care and prudence. Treas. Reg. 53.4945-6(b)(2). Reasonableness is determined upon a case by case facts and circumstances determination. Treas. Reg. § 53.4945-6(b)(2); Rev. Rul. 77-161. Expenses should be able to be validated by the foundation and somehow associated with the exempt purpose of the organization or the payment of the expenses may be construed to be “private benefit” and risk the exempt status of the organization.

b. Set-Asides: Money set aside or saved for specific future charitable projects rather than being paid out currently can be considered to be qualifying distributions in the year earmarked for the project. There are two very different types of set-asides. For the first type, the foundation must have plans to use the money within 60 months of after its set-aside for a specific project and meet a suitability test. Prior IRS approval is required for this type before the reserved funds can be claimed as a qualifying distribution. In a second type, a newly created organization with a plan that could achieve IRS suitability requirements must simply satisfy a mathematical test without requesting formal approval.

3. Calculating the 5% Distribution Amount:

a. Value of Assets: The foundation first must calculate the value of its assets not held for exempt purposes. Different methods, revaluation times, and frequencies are provided for various types of investment assets that a private foundation might own.

i. Valuation Methods: Any “commonly acceptable method of valuation” may be used as long as it is reasonable and consistently used. Valuations made in accordance with the methods prescribed for estate tax valuation are acceptable. The opinion of an independent appraiser is only required for real estate for which the foundation wishes to rely upon the value calculated for five years. For all other assets, the foundation can itself establish a consistent method for making a good-faith determination of the value.

ii. Frequency of Valuation: The value of cash held by the foundation is calculated by averaging the beginning and ending balances of the foundation’s cash accounts for each month during the tax year. The value of publicly-traded securities held by the foundation is calculated by averaging the ending balances of such securities for each month during the tax year. The value of all other assets is determined annually. The only exception is for real estate. If the foundation obtains a certified independent appraisal of the value of its real estate, it may use that value for up to 5 tax years.

iii. Partial Year: The value of an asset (other than cash or publicly-traded securities) held by the foundation for part of a year is calculated by using the number of days in the year that the asset was held as the numerator and the number of days in the tax year (usually 365) as the denominator. This ratio is then multiplied by the annual value determined following methods above.
b. 1.5% Reduction: The fair market value of the foundation’s assets may be reduced by 1.5% of the “cash deemed held for charitable purposes.” This takes into account that any foundation needs cash to conduct its ongoing business operations.

c. Calculate 5% of net of (a) & (b): Multiply the net of (a) & (b) by 5%. (For a partial year, the 5% is multiplied by a ratio calculated by using the number of days in the tax year as the numerator, and 365 as the denominator.)

d. The net figure obtained in (c) above is reduced by taxes paid by the foundation during the year and increased by recoveries of qualifying distributions (i.e. returned grant funds). This is the “distributable amount” that the qualifying distributions must equal each year. Note Pertaining to Estates: Treas. Reg. § 53.4942(a)-2(c)(2)(ii) provides that the asset base for determining the minimum investment return of a private foundation does not include “the assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for federal income tax purposes pursuant to Treas. Reg. § 1.641(b)-3.

4. If such amount is not distributed by the close of the following taxable year, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount which should have been distributed. An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made. The penalties apply only to the foundation and not the foundation manager.

D. Excess Business Holdings (I.R.C. §4943): To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation’s ability to engage in certain business activities.

1. Permitted holdings: The foundation may own up to 20% of the voting stock in a corporation, reduced by the percentage of voting stock held by all Disqualified Persons. If control of the entity can be shown to be held by Non-Disqualified Persons, the foundation and the Disqualified Persons may own up to 35% of the entity’s voting interest. The foundation may hold a non-voting interest, but only if all Disqualified Persons together hold no more than 20% of the voting interest or no more than 35% of the voting interest if effective control is with a Non-Disqualified Person(s). The foundation may own up to a de minimis 2% of the voting stock or value without having to consider amounts owned by Disqualified Persons for the purpose of excess business holdings.

2. 5 year period to dispose: A private foundation has 5 years to dispose of excess business holdings acquired by gift or bequest. The disposal must be to a non-Disqualified Person. Additionally, during the 5 year period, the excess business holdings will be treated as held by a Disqualified Person (rather than by the foundation).

3. Unusual gifts and bequests: A private foundation may be granted an additional 5 year period to dispose of an excess business holding received by an unusually large gift or bequest, or holdings with complex business structures.
4. Business enterprise: The private foundation is not permitted to retain excess business holdings, as defined in I.R.C. §4943(c). For the entity in which an interest is held to be considered a business holding, it must be engaged in a business enterprise. An entity is not engaged in a business enterprise if 95% or more of gross income is from passive activity, I.R.C. § 4943(d)(3), or if the business is a functionally related business (i.e. to the foundation’s charitable purpose) defined in I.R.C. § 4942(j)(4). Investment in such assets as passive rental real estate or marketable securities is not a business enterprise.

5. The foundation is taxed on its excess business holdings in the amount of 10% of the value of the excess business holding. A penalty of 200% is imposed on the foundation if the initial penalty is assessed and the excess business holding is not timely corrected. I.R.C. § 4943(b). Although the private foundation has a 5 year time period to dispose of the excess business holding, the disposition of such holding is subject to the restrictions against acts of self-dealing.

E. Jeopardizing Investments (I.R.C. §4944): The private foundation must not make investments which would jeopardize the carrying out of its exempt purposes. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers’ standard of care. The foundation managers will be held to a “prudent investor” standard of care. Caution should be exercised in the consideration of speculative investments such as working interests in oil and gas, trading on margin, trading in commodity futures, purchase of “puts” and “calls” and “straddles”, warrants, selling short or other high risk investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest. If it does apply, a tax is imposed on the foundation equal to 10% of the amount of the improperly invested assets. Additionally, each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation’s exempt purposes is assessed a tax of 10% of the amount of the improper investment (not to exceed $20,000 for each such act). If the jeopardizing investment is not disposed of within the taxable period, the foundation is assessed an additional tax of 25% of the amount improperly invested and each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation’s exempt purposes is assessed an additional tax of 5% of the amount of the improper investment (not to exceed $20,000 for each such act). The taxable period begins on the date of investment and ends the earlier of (i) the date of the mailing of a deficiency; (ii) the date on which the tax is assessed; or (iii) the date on which the investment is removed from jeopardy.

F. Taxable Expenditures (I.R.C. §4945): A private foundation is prohibited from making expenditures not in furtherance of the foundation’s exempt purposes. Taxable expenditures include amounts paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation or the outcome of any public election. Additionally, if the foundation makes a distribution to another private foundation or a for-profit entity, it must monitor (i.e., exercise expenditure responsibility) the grant in order to avoid a penalty.

1. Grants to the following types of organizations require expenditure responsibility to avoid making a taxable expenditure: §509(a)(3), Type III-Other supporting organizations, private foundations, and non-§501(c)(3) organizations. Exercise of expenditure responsibility
includes the conducting of a pre-grant inquiry concerning grantee’s management and programs, obtaining a written agreement from the grantee prior to making the grant, obtaining regular written status reports from the grantee regarding its progress in using the grant, and filing reports regarding the grant’s status with the private foundation’s annual information return and checking the appropriate box.

2. Grants to Individuals: If the foundation intends to make grants to individuals for travel study, or similar purposes, advance written approval of the selection process must be received from the Internal Revenue Service or such grants will be subject to tax. I.R.C. § 4945(g). Grants to individuals for purposes other than study, travel or similar purposes do not require Internal Revenue Service approval but the foundation should exercise diligence to ensure these grants are used for charitable purposes.

a. A request for approval of the grant selection process to individuals must contain the following:\(^1\):

i. Statement describing the grantee selection process;

ii. Description of the terms and conditions under which the foundation ordinarily makes such grants, in sufficient detail to enable the Commissioner to determine whether the grants awarded would meet the foundation’s exempt purposes (charitable, etc.).

iii. Detailed description of the foundation’s procedure for exercising supervision of scholarship and fellowship grants;

iv. Description of the foundation’s procedure for reviewing grantee reports and for investigating or correcting possible misuse of grant funds by the recipient; and

v. A user fee.

b. The foundation is not required to have a written agreement from the prospective grantee and does not have to have written approval of each grant program. The approval is to provide for an evaluation of the foundation’s entire system of standards, procedures, and follow-up in order to evaluate if grants will meet required standards. Treas. Reg. § 53.4945-4(d). As long as the foundation’s procedures for selection are not altered, the approval will continue to apply. Treas. Reg. § 53.4945-3(iii)(a), (b) and (c).

c. The grant must also be one of the following three types:

i. A grant constituting a scholarship or fellowship grant which would be subject to the provisions of I.R.C. § 117(a). Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(1),

---

\(^1\) Note that completing Schedule H of Form 1023 is the procedure for foundations seeking advance approval at the time of formation; otherwise, a private letter ruling should be requested.
(i.e., the grant would not be included as gross income by the grantee because it is received by an individual who is a candidate for a degree at an educational institution.) The grant must be used for tuition and fees for enrollment or attendance at the educational institution or for fees, books, supplies, and equipment required for courses of instruction at the educational institution. I.R.C. § 117(a); or,

ii. The grant must constitute a prize or award, and the recipient of the prize or award must be selected from the general public. The prize or award must be such that it would be subject to the provisions of I.R.C. § 74(b), except for the requirement to transfer the prize to a charity. Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(2). I.R.C. § 74(b) requires prizes or awards to be made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. Furthermore, (i) the recipient must be selected without any action on his or her part to enter the contest or proceeding and (ii) the recipient must not be required to render substantial future services as a condition to receiving the prize or award; or,

iii. The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance literary, artistic, musical, scientific, teaching, or other similar capacity, skill or talent of the grantee. Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(3). “Specific objective . . . or other similar product” is intended to encompass purposes which are sufficiently narrow and definite to ensure that grantees only be able to use funds in furtherance of charitable purposes. Rev. Rul. 77-434. Long-term, low-interest educational loans may fit into this category provided their use is sufficiently limited.

d. Supervision of Grants: Standards for supervision of scholarship and fellowship grants are set forth in the Treasury Regulations and provide that the foundation must arrange to receive a “verified” report from the appropriate educational institution at least once for each year in which the grantee takes courses and receives grades. If the grant involves research, projects, or other work not involving the taking of actual courses, the foundation manager must receive an annual progress report approved by the faculty member supervising the grantee or by another appropriate university official. The foundation must receive a final report upon completion of the grantee’s studies. Treas. Reg. § 53.4945-4(c)(2). The foundation must be able to ensure that the grantees have not diverted funds away from the original purpose of the grant. If the foundation fails to investigate or correct grant misuse, the grant may become a taxable expenditure. Treas. Reg. § 53.4945-4(c)(4). The Treasury Regulations do provide an alternative to the above mentioned supervisory requirements for scholarship and fellowship grants. Treas. Reg. 53.4945-4(c)(5). The foundation need not receive reports or investigate grants which may be being misused if the following criteria are met:
i. The scholarship or fellowship grants are excludable from the recipient’s gross income and are used for study at an educational institution described in I.R.C. § 151(e)(4); and,

ii. The grantor pays funds directly to the educational institution and not to the individual grantee; and,

iii. The educational institution agrees to use the grant funds directly to defray the recipient’s expenses, or to pay the funds (or portion thereof) to the recipient only if the recipient is enrolled at the institution and his or her standing at the institution is considered with the purposes of the grant.

e. The private foundation must retain records pertaining to all grants to individuals for travel, study, or other similar purposes. Treas. Reg. § 53.4945-4(d). These records must include:

i. All information the foundation secures to evaluate the qualifications of potential grantees.

ii. The identification of grantees. This should include any relationship of any grantee to,
   1. members, officers, trustees of the organization,
   2. a grantor or substantial contributor to the organization or a member of the family of either, and
   3. a corporation controlled by a grantor or substantial contributor. Rev. Rul. 56-304.

iii. Specification of the amount and purposes of each grant.

iv. Any follow-up information which the foundation obtains regarding possible misuse of funds.

3. A grant meeting all of the above may still constitute a taxable expenditure if, (i) the grant is to be used to attempt to influence legislation or affect the outcome of a public election, or (ii) there is an agreement between the fund and the grantee whereby the fund may cause the grantee to engage in and the grantee does engage in such an activity, or (iii) the grant is made for a purpose other than religious, charitable, scientific, public safety, literary, or educational purposes, fostering of national or international amateur sports competition, or prevention of cruelty to children or animals. Treas. Reg. § 53.4945-4(a)(5).

4. Distributions to Foreign Organizations or for Foreign Purposes: A foundation can make a contribution to a foreign organization and it not be deemed a taxable expenditure if the foreign organization has received a tax exempt determination letter from the Internal Revenue Service that it is a public charity or it qualifies as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3); Treas. Reg. § 53.4945-6(c)(1), I.R.C. § 4945(d)(4)(A); or, if in the reasonable judgment of a foundation
manager, it is determined that the foreign organization will be treated as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3), Treas. Reg. § 53.4945-6(c)(2)(ii), and a good faith determination is made based upon an affidavit of the foreign organization or an opinion of counsel (proposed regulations expand this to include other qualified tax practitioners) by either the foreign organization’s or the foundation’s counsel, setting forth sufficient facts concerning the operation and support of the organization to enable the Internal Revenue Service on audit to determine that the grantee organization would likely qualify as a public charity under I.R.C. § 509(a)(1), (2) or (3). Treas. Reg. § 53.4945-5(a)(5). There is no requirement that the affidavit or opinion of counsel be attached to the donor foundation’s annual information return. Treas. Reg. § 53-4942(a)-3(a)(6)(i). The foundation can make a grant to a foreign organization not meeting these requirements only if the foundation exercises expenditure responsibility as to the grant. If the contribution is made to a domestic organization which is to be used for a charitable activity in a foreign country, the domestic organization will be considered the recipient of the contribution and the contribution will be a qualifying distribution if the use of the contribution is subject to the domestic organization’s discretion and control. Rev. Rul. 66-79, 1966-1 C.B. 48. However, the donating foundation must not earmark the contribution to the domestic organization directly for the use of the foreign organization. If they do, they will be deemed to have made a grant directly to the foreign organization and the foreign organization must meet the qualifications of a public charity in order for the distribution to be a qualifying distribution. As long as the donating foundation does not earmark the use of its grant for any named secondary donee, it will not be deemed to have made a contribution to the secondary donee. Treas. Reg. § 53.49429(a)-3(c)(4). Care should be taken to comply with anti-terrorism measures to ensure funds are not diverted to terrorist purposes. That discussion is beyond the scope of this paper.

5. Recordkeeping: Review procedures should be adopted and records kept to document that a private foundation is not making taxable expenditures. These procedures should include:

a. Verification of grantee’s public charity status (e.g. §509(a)(1), (2), or (3)). Approved methods include (1) checking EO Select Check to see if organization is currently listed as a public charity along with copy of current IRS letter showing public charity status, (2) checking IRS Business Master File to see organization’s public charity status, or (3) use of third party verification software such as Guidestar’s Charity Check or Foundation Source’s Grant Safe. If the grantee is classified as a §509(a)(3) supporting organization, additional steps must be taken to determine what Type (I, II, III-Functionally Integrated, or Type III-Other) the organization is. Grants to Type III-Other supporting organizations require expenditure responsibility to avoid a taxable expenditure and do not count as qualifying distributions.

b. Review of the grantee’s current 990, Schedule A to review its proof of non-private status and that is still classified as a public charity; and,

c. Filing reports regarding the grant’s status with the private foundation’s annual information return and checking the appropriate box pertaining to expenditure responsibility.
d. Documenting exempt purpose of the program to be funded either through a grant request which describes the program or a transmittal letter accompanying the grant which describes the purpose.

6. The foundation is subject to a 20% tax on each taxable expenditure, and any foundation manager who willingly participates in making the distribution knowing it is a taxable expenditure, without reasonable cause, is subject to a 5% tax on such taxable expenditure. If the expenditure is not corrected within the taxable period, the foundation is subject to a tax of 100% of the amount of the taxable expenditure and the foundation manager is subject to a tax of 50% of the amount of the taxable expenditure, if the foundation manager refused to correct the transaction. The taxable period is the date starting when the expenditure is made and ending the earlier of the date (i) of mailing of a notice of deficiency; or (ii) the tax is assessed).

V. QUALIFICATION AS A PRIVATE OPERATING FOUNDATION

A. Advantages:
   One private foundation that is given some of the advantages of being treated as a public charity is the private operating foundation. Becoming a private operating foundation is as simple as changing the organization’s manner of operations, something that is within the control of the members, and does not result in termination of private foundation status. Although these private foundations continue to be subject to most rules affecting private foundations, donors receive more favorable tax deductions for donations to such. (Note: Certain “exempt” operating foundations are exempt from the net investment income tax applicable to nonoperating private foundations discussed above.) Typically, these organizations actively operate as a charity, rather than making grants to other charities. Unless these organizations are able to raise substantial contributions from the general public, they are classified as private foundations subject to the rules and excise taxes concerning private foundations discussed above.

B. Private Operating Foundation Tests:
   To qualify as a private operating foundation, an organization must meet the “income test” and any one of the 3 following tests: 1) the “assets test”, 2) the “endowment test,” and 3) the “support test.” See Treas. Regs. § 53.4942(b)-1(a)(1).

   1. “Income Test”: The organization must distribute substantially all of the lesser of its adjusted net income or its minimum investment return directly for the active conduct of its exempt purposes. Distributions that count towards this test do not include grants to other organizations, but may include grants, scholarships or other payments to individuals if the organization is involved in the programs in support of which the grants, etc. were made. “Substantially all” is defined to mean 85% or more. Treas. Regs. § 53.4942(b)-1(c). “Adjusted net income” is defined as gross income less deductions allowable to a corporation, subject to certain modifications. See I.R.C. § 4942(f)(2); Treas. Regs. § 53.4942(a)-2(d)(2). It does not include gifts, grants or contributions but does include income from a functionally related business. Treas. Regs. § 53.4942(a)-2(d)(1). “Minimum investment return” is equal to 5% of the assets not used directly in carrying out the organization’s exempt function, after subtracting the amount of any acquisition
indebtedness (under I.R.C. § 514(c)(1)) with respect to any property. [This is the same definition as that used to calculate the minimum distribution for a private foundation.] Excluded interests include any future interest in income or corpus of property, any interest in an estate before receipt, any interest in a trust created or funded by another person, and any pledge to the foundation, enforceable or otherwise. See Treas. Regs. § 53.4942(a)-2(c)(2)(i)-(iv).

2. Three Alternative Tests:

   a. “Assets test”: Requires that substantially more than ½ of the organization’s assets be held for use for the organization’s exempt function activities. I.R.C. § 4942(j)(3)(B)(I); Treas. Regs. § 53.4942(b)-2(a). “Substantially more” than ½ is defined to mean 65% or more. Treas. Regs. § 53.4942(b)-2(a)(5). These assets must be devoted directly to either the active conduct of the organization’s exempt purpose or functionally related business or any combination of these two. Treas. Regs. § 53.4942(b)-2(a)(4) and –2(c)(4) contain the rules for valuing the assets; or

   b. “Endowment Test”: Requires direct distributions of at least 2/3 of the foundation’s minimum investment return. I.R.C. § 4942(j)(3)(B)(ii); Treas. Regs. § 53.4942(b)-2(b). [All definitions are the same as those provided under the “income test” described above.]; or

   c. “Support Test”: Requires that at least 85% of the organization’s support (excluding gross investment income) be from a combination of the general public and 5 or more exempt organizations and not more than 25% of support (other than gross investment income) be from any one exempt organization, and not more than 50% of support be from gross investment income. I.R.C. § 4942(j)(3)(B)(iii); Treas. Regs. § 53.4942(b)-2(c)(1). “Support” includes gifts, grants, contributions, membership fees, gross receipts from admissions, sales of merchandise, performance of services, furnishing facilities, net income from unrelated business activities, gross investment income, tax revenues and the value of services or facilities furnished by a governmental unit without charge. I.R.C. § 509(d).

3. Computation Periods: The tests for qualifying as a private operating foundation are based upon the year in question and three immediately preceding years and may be met either on an aggregate basis or on a 3 out of 4 years basis. Treas. Regs. § 53.4942(b)-3(a). The 3 out of 4 years basis is only available, therefore, in the fourth year of the test. See TAM 9108001. New organizations must use the aggregate method for each of the first three years of existence. Treas. Regs. § 53.4942(b)-3(b)(1). A new organization may be treated as an operating private foundation for its first year if the organization makes a good faith determination (based on an affidavit or opinion of counsel which sets forth facts) that it will meet the private operating foundation tests for its first year. Treas. Regs. § 53.4942(b)-3(b)(2).
4. Tax On Undistributed Income: Private operating foundations are not subject to the excise tax on undistributed income under I.R.C. § 4942.

5. Income Tax Deduction: Because the private operation foundation is treated as a public charity for purposes of donors’ charitable contributions, the limitations on contributions to public charities apply to any such contributions.

   a. Fifty Percent (50%) Limitation - Limit applicable to cash charitable contributions to public charities. Contributions in excess of 50% of Adjusted Gross Income may be carried over to the 5 succeeding taxable years.

   b. Thirty Percent (30%) Limitation - Limit applicable to charitable contributions of appreciated property to public charities. Contributions in excess of 30% of Adjusted Gross Income may be carried over to the 5 succeeding taxable years.

6. Creation of Organization: A private operating foundation is created in the same manner as a nonoperating private foundation and is generally subject to the same reporting requirements described for nonoperating private foundations described above.

VI. OPERATIONS AND ANNUAL FILINGS

A. Operations:

1. The Board of Directors: The board of directors establishes policy of the foundation in accordance with its purposes as set forth in the entity’s organizational documents. It also works with donors in acceptance of donations and using the foundation’s assets in accordance with its exempt purpose.

2. Hiring Professional Management: Staff may be needed to administer the programs and handle operations. Directors of the private foundation usually delegate day-to-day management to an executive committee or an executive director. However, a small private foundation that makes grants only once per year generally operates without the necessity of a staff. Directors should, however, hire appropriate professional advisors as warranted.

   a. Delegation of Authority to Invest:

      1) Trusts: The Uniform Prudent Investor Act (Chapter 117 of the Texas Trust Code) was adopted in 2003. It replaces the modified “prudent man” investment standard with the “prudent investor” rule based on the American Law Institute’s Restatement (third) of Trusts: Prudent Investor Rule (1992). Under the Uniform Prudent Investor Act, the Trustee must generally diversify the assets of the trust. The Act also codifies the common law duties of loyalty and impartiality. The Trustee may delegate investment and management functions, but may be held liable for actions of the agent under certain circumstances. (See
Section 117.011 of the Texas Trust Code). These standards apply effective January 1, 2004 to new and existing trusts.

2) Corporations: The Board of Directors of a nonprofit corporation is not subject to liability for any action or omission by an advisor if the Board of Directors has acted in good faith and with ordinary care in selecting the advisor. Texas Rev. Civ. Stat. art. 1396-2.29; Texas Business Organizations Code (“BOC”) § 22.224. The Board of Directors can contract with appropriate investment advisors, trust companies, banks, investment counsel or managers and delegate to them full power and authority to: (i) purchase or otherwise acquire stocks, bonds, securities, and other investments on behalf of the corporation; and (ii) sell, transfer or otherwise dispose of any of the corporation’s assets and properties at a time and for a consideration that the advisor deems appropriate.

3. Developing Operating Procedures: Operating procedures should be adopted and strictly followed so as to avoid excise tax complications and avoid jeopardizing the private foundation’s charitable status. These procedures include grant application guidelines, and should include, where necessary, review and compliance with procedures to be followed when making grants to foreign grantees, individuals or non-charitable entities. A written statement about the foundation’s guidelines, policies, programs of interest, any geographic limitations or other restrictions should be adopted by the board of directors.

4. Making Grants: Grants are distributions by the foundation to other organizations to perform charitable activities within their domain and under their control and such grants must be in an annual amount of at least 5% of the annual fair market value of foundation’s assets not used directly to carry out the foundation’s exempt purposes, after considering certain qualifying expenses. These grants may be to public charities (those which have received an IRS determination letter stating that the organization is an I.R.C. § 501(c)(3) organization and that it is not a private foundation because it is either classified under I.R.C. § 509(a)(1), 509(a)(2) or 509(a)(3)) or to a governmental unit such as a school board, fire department or public library (as long as the purpose for the grant is a charitable purpose) or to social welfare or civic action organization (under I.R.C. § 501(c)(4)), or trade associations and professional organizations (under I.R.C. § 501(c)(6), such as trade associations, chambers of commerce, real estate boards, boards of trade and similar professional organizations.) However, grants to such civic action organizations or social welfare organizations or trade associations and professional organizations require the foundation to conduct expenditure responsibility in order to avoid penalties. (See discussion regarding “expenditure responsibility.”)

a. Grant Making Policy: The foundation should establish policies defining programs of interest and establishing objectives to be served. It should also establish its function and position as how to further its charitable purpose. Many private foundations designate a grant committee to review grant applications and make recommendations to board of directors.
b. Grant Application Guidelines: Processes for receiving, examining and deciding on grant applications should be established on a clear and logical basis and should be followed in a manner consistent with the organization’s policies and purposes. The foundation’s written statement about the foundation’s guidelines, policies, programs of interest, any geographic limitations or other restrictions should be provided to applicants. Status reports to applicants should be given promptly.

c. Discretionary Grants: The board of directors may also establish a policy allowing each board member to designate grantees of his or her own choosing up to a predetermined amount. An advantage to discretionary grants is that if each board member can designate a portion of the minimum distribution amount, then he or she would not be as self-motivated on discussing and deciding upon the distributions of the remaining minimum distribution amounts, but a conflict of interest may arise as to the director making decisions in favor of certain grantees.

d. Review of Applications: The directors may evaluate applications and put into written form their interests in certain applications. Foundation staff may further investigate potential grants.

e. Grant Agreement: The foundation should require each grantee to sign a Grant Agreement which binds the grantee to use the grant funds for the purposes provided.

f. Reclaiming of Grant Funds: If the grantee fails to follow the Grant Agreement, the foundation can demand repayment of the grant funds.

g. Recordkeeping: The foundation should obtain and maintain documentation reflecting that distributed funds were used for charitable purposes. These records should include:

1) A copy of any Grant Agreement;
2) Reports regarding grant, if any;
3) Copy of grantee’s IRS tax exempt determination letter and documentation that EO Select Check was consulted (available at www.irs.gov and the relevant portion can be printed for the file); and if the grantee is not a public charity, the foundation must keep complete documentation on its expenditure responsibility (see discussion above), or, in the case of a grantee that is a non-U.S. charity, equivalency determination documentation (see discussion above).

h. Tipping: Generally, a public charity must continually meet a public support test evidencing that a percent of its funding is obtained from a broad cross-section of donors of the general public, not from one foundation or one person. A large grant to a small public charity may cause the public charity to fail to meet its public support test and “tip” it into private foundation status. If the foundation’s grant to the public charity tips the public charity, no penalty will be
imposed upon the granting foundation if: 1) the grantee had an IRS tax exempt
determination letter at the time of the grant, 2) the Service had not revoked the
letter and the foundation was not aware of imminent action to do so by the IRS;
and 3) the foundation did not control the grantee.

i. Grants to Entities of Which a Disqualified Person Serves on the Board of
Directors:

1) Self-Dealing: The foundation may make a distribution to an organization
on which a Disqualified Person serves on the board of directors without violating
the rules against self-dealing if the Disqualified Person only receives an incidental
and tenuous benefit from the grant. See Treas. Reg. § 53.4941(d)-2(f)(2). See
also Rev. Rul. 75-42, 1975-1 C.B. 359, where the Service determined that two
individuals serving as trustees of both organizations did not violate rules against
self-dealing because the benefit to Disqualified Persons was only incidental; and
Rev. Rul. 82-136, 1982-2 C.B. 300, where the Service determined that a violation
of rules against self-dealing did not occur where a bank served as trustee of two
foundations where one was making a grant to the other and determined that any
benefit received by the Disqualified Person (the bank) was incidental. Determinations
should be made on a case by case basis as to whether any benefit
is incidental or tenuous.

2) Qualifying Distribution: A distribution from the grantee organization is
not a qualifying distribution if the donor organization is a “controlled
organization”.

(a) Controlled Organization: An organization is treated as controlled by the
private foundation if one or more of its Disqualified Persons may by aggregating
their votes or positions of authority, require the donee organization to make an
expenditure or to prevent it from making an expenditure, regardless of the method
by which the control is exercised or exercisable. Treas. Reg. § 53.4942(a)-
3(a)(3). This is the case whether or not such control is actually exercised.

(b) However, even if the donee organization is a controlled organization, a
grant from a foundation will still qualify as a qualifying distribution if within the
year in which the grant is made:

(1) The donee organization expends for charitable purposes described
in I.R.C. § 170(c)(2)(B) an amount equal to the value of the grant not later
than the end of the recipient’s first taxable year after the taxable year in
which the grant is received;
(2) If the recipient is a private operating foundation, the redistribution
is treated by the foundation as made out of corpus, as if the charity were a
private nonoperating foundation; and,
(3) The donor foundation obtains adequate records or other sufficient
evidence reflecting that the redistribution has been made, the names and
addresses of the recipients of the redistributed amount and the amount received by each, and that the redistribution would be treated as made from corpus as if the public charity were a private nonoperating foundation. I.R.C. § 4942(g)(3); Treas. Reg. § 53.4942(a)-3(c)(1).

5. Advisory Board: Often directors form an advisory board to advise them on policy matters. This advisory board is generally made up of professionals and other persons having expertise in differing areas that impact the foundation. This board lacks governing authority over the private foundation and cannot legally bind the private foundation.

6. Governance: The private foundation through its board of directors, committees and managers, should adopt policies as to governance and other related matters.

7. Compensation and Other Expenses: No part of the net earnings of a private foundation may inure to the benefit of any individual. Private inurement can cause the exempt organization to lose its tax exempt status. However, payments of compensation that are reasonable and necessary and not excessive may be paid to employees, consultants and others. Such compensation does not violate the restriction upon acts of self-dealing. Directors of private foundations often, however, serve without compensation. The private foundation may pay for the directors’ liability insurance and reimburse the director for out-of-pocket expenses (subject to the restrictions upon acts of self-dealing). Federal law requires that the salaries and benefits of the private foundation’s highest paid employees (>50,000) and all directors be disclosed to the public on the foundation’s annual information return.

8. Outside Audit: Although not required, many foundations obtain outside audits to shield the directors from potential liability.

9. Insurance: Private foundations should and generally do purchase liability insurance and property insurance. Often, the insurance includes that for officers and directors (“D&O Insurance”). D&O Insurance protects the foundation and the directors from the costs of legal defense and the payment of certain losses where there is no bodily injury or property damage but is generally resulting from some wrongful act, including breach of duty, neglect, error, misstatement, misleading statement, omission, or other acts done or wrongfully attempted. Claims generally covered included those for wrongful termination, discrimination in employment, sexual harassment, breach of fiduciary duty, self-dealing violations and failure to timely file tax returns. The D&O policy generally is designed to pay attorney’s fees and court costs.

10. Employment: The private foundation must comply with all federal, state and local employment laws, including withholding and other taxes applicable to private sector employers.

11. Documents Subject to Inspection: Applications for exempt status, annual returns (Form 990-PF) and unrelated business income tax returns (Form 990-T) must be made
available for public inspection at the private foundation’s office. Annual returns for many exempt organizations are available at www.guidestar.org.

B. Form 990-PF, Return of Private Foundation: Each private foundation must file an annual information return, Form 990-PF, on or before the 15th day of the fifth month following the close of the foundation’s annual accounting period, which is generally May 15 if the foundation is on a calendar year. All foundations are on a calendar year reporting basis unless a fiscal year is elected. The Form 990-PF is required to be filed also with the Attorney General of any state in which the principal office of the foundation is located, the foundation was incorporated or created, or to which the foundation reports in any fashion concerning its organization, assets, or activities. The deadline for filing Form 990-PF may be extended by filing Form 8868. The foundation may be fined $20 (or $100 for larger foundations) per day for failing to timely file Form 990-PF.

1. Public Inspection of Form 990-PF: Under I.R.C. §6104(d), a tax-exempt organization, including a private foundation, must allow public inspection at its principal office (and at certain regional or district offices) and to comply with such requests, made either in person or in writing, for copies of the organization’s application for recognition of exemption and the organization’s three most recent annual information returns. An “annual information return” is defined to include any return that is required to be filed under I.R.C. § 6033 (meaning Form 990-PF and Form 4720 pertaining to private foundations). The private foundation must also, unlike other tax-exempt organizations, disclose to the general public the names and addresses of contributors, consistent with I.R.C. § 6104(d)(3). The term “tax-exempt organization” includes nonexempt private foundations and nonexempt charitable trusts described in section 4947(a)(1) that are subject to the information reporting requirements of I.R.C. § 6033.

C. Form 990-T, Exempt Organization Business Income Tax Return: If the private foundation has $1,000 or more of gross unrelated business income, it must file a return to report and pay tax on that unrelated business taxable income, if any. The foundation may be required to pay tax quarterly using Form 990-W Estimated Tax on Unrelated Business Taxable Income. Pursuant to the Pension Protection Act of 2006, a private foundation must allow public inspection of its Form 990-T to the same extent as inspection of its Form 990-PF.

D. Form 4720, Return of Certain Excise Taxes under Chapters 41 and 42 of the Code: If the private foundation or a disqualified person is liable for any of the penalties described in IRC §§4941-4945, Form 4720 must be filed to report and pay such penalties. It is due at the same time as the Form 990-PF.

E. Forms Relating to Alternative Investments: If the private foundation has a foreign bank account or is invested in a foreign hedge fund taxed as a partnership or a corporation, it may have to file one or more of the following forms: TD F 90-22.1, 926, 5471, 8621, and 8865. With the exception of TD F 90-22.1 which is filed separately each year by June 30, the other forms are attached to the foundation’s Form 990-PF.
F. State Reports: In addition to furnishing the Attorney General with a copy of form 990-PF, the Foundation should file the following, if applicable:

1. Texas Franchise Tax Public Information Report: This report must be filed with the Texas Comptroller of Public Accounts even if no franchise tax is payable by the foundation (until exemption is obtained – see below).

2. Texas Corporation Franchise Tax Report: The foundation may be requested to file this report if it is a corporation. Generally, no tax will be due. If this report is due before the foundation is granted exempt status and any tax is due, the foundation may be able to receive a refund of the tax, if any is due, upon receipt of the foundation’s exemption.

3. BOC 22.357 Report: Every four years, the foundation may be required to file with the Texas Secretary of State a report which states the name of the corporation, its address, the name and address of its registered agent and the names and addresses of its officers and directors.

4. Texas Workforce Commission Status Report: If the foundation has 4 or more employees, it must complete a Texas Workforce Commission Status Report and file it with the Tax Department of the Texas Workforce Commission (formerly Texas Employment Commission).

G. Employer Returns: If the foundation has employees, it must withhold, deposit, pay and report federal income taxes, social security taxes, and federal unemployment taxes, unless specifically excluded by statute.

H. Substantiation Documentation: A charitable organization must issue substantiation letters to its donors where the donation has a value of $250 or more and the donor desires to claim a charitable income tax deduction for the donation. The substantiation must be in writing and must be obtained before filing the tax return for the tax year in which the deduction is claimed. Because the charitable organization does not seek a charitable deduction under I.R.C. § 170, (except for charitable deductions claimed on Form 990-T) it is not generally required to obtain and retain substantiation letters from the charities it supports. Note that donors who itemize deductions must have a bank record or a written communication from the charity to substantiate any monetary contribution (cash, check or other monetary gift), regardless of the amount, effective January 1, 2007. Additionally, if the gift received is appreciated property and is sold within 3 years of acquisition, the foundation must prepare and file Form 8282. Publication 1771, Charitable Contributions – Substantiation and Disclosure Requirements, explains the federal tax law for organizations such as charities and churches that receive tax-deductible charitable contributions and for taxpayers who make contributions. Publication 1771 allows written acknowledgement to be provided electronically, such as via e-mail addressed to the donor.
VII. TERMINATION OF PRIVATE FOUNDATION STATUS:

Once an organization is classified as a private foundation, it may only terminate that status under the provisions of IRC §507. Under that section, there are five ways to terminate private foundation status, two of which involve tax liability.

A. Voluntary termination by notifying the IRS of intent to terminate and paying a termination tax: To voluntarily terminate under IRC §507(a)(1), the organization must send a statement to the Manager, Exempt Organizations Determinations (Internal Revenue Service, Exempt Organizations Determinations, P.O. Box 2508, Cincinnati, OH 45201) of its intent to terminate its status under section 507(a)(1). The statement must provide, in detail, the computation and amount of private foundation termination tax. Unless the organization requests abatement, it must pay the tax at the time the statement is filed.

B. Involuntary termination for either willful repeated violations or a willful and flagrant violation of the private foundation excise tax provisions and becoming subject to the termination tax: This is the ultimate penalty for failure to comply with the excise tax rules Congress designed to curtail private foundation operations and is sometimes referred to as the third-tier tax. The termination tax does not apply to termination of a foreign private foundation that has received substantially all of its support, other than gross investment income, from sources outside the United States.

C. Transfer of assets to certain public charities: A private foundation may terminate its status under IRC §507(b)(1)(A) by distributing all its net assets to one or more organizations with a ruling or determination letter described in IRC §509(a)(1). However, the organization to which the distribution is made must have been in existence and so described for a continuous period of at least 60 months before the distribution. A private foundation that terminates its status in compliance with IRC §507(b)(1)(A) is not required to notify the IRS of its intent to terminate, and does not owe the termination tax. A foundation may request a determination regarding the termination. If the public charity receiving the foundation’s funds is not described in §509(a)(1) but instead in §509(a)(2) or (3), the termination is not automatic. However, no termination tax is due because the foundation has no assets.

D. Operating as a public charity for a continuous period of 60 months after giving appropriate notice: An organization may terminate its private foundation status under IRC §507(b)(1)(B) if it meets the requirements of §509(a)(1), (2), or (3)) for a continuous 60-month period beginning with the first day of any tax year, and notifies the Service before beginning the 60-month period that it is terminating its private foundation status.

The notice of termination of private foundation status via operation as a public charity should include:

1. The name and address of the private foundation,
2. Its intention to terminate its private foundation status,
3. The Code section under which it seeks classification (section 509(a)(1), (2), or (3)),
4. If section 509(a)(1) applies, the specific type of section 170(b)(1)(A) organization for which it seeks classification,
5. The date its regular tax year begins, and
6. The date the 60-month period begins.

The organization also must establish immediately after the end of the 60-month period that it has met the requirements of section 509(a)(1), (2), or (3).

E. Transfer of assets to one or more private foundations: A foundation may also transfer its assets to another private foundation, commence voluntary termination, and pay no termination tax because it has no assets.
1. When 25 percent or more of a foundation’s assets are transferred, called a “significant disposition of assets,” to one or more other private foundations, certain attributes of the granting foundation carry over to the recipient private foundation(s). These attributes include the aggregate tax benefit associated with the assets, the substantial contributors of the grantor foundation are now considered to be substantial contributors of the grantee foundation, and transferred assets are subject to any unsatisfied Chapter 42 (IRC §§4940-4945) tax liability of the grantor foundation.
2. When 100 percent of a foundation’s assets are transferred to a commonly controlled foundation or foundations, the grantee foundations are considered to be the grantor foundation with respect to §§4940-4945 in proportion to the assets received. For example, if the grantor foundation has excess grant carryovers of $100,000 and it transfers all of its assets to two commonly controlled foundations equally, then each grantee foundation will succeed to $50,000 of excess grant carryovers.
3. The rules regarding these types of transfers – referred to as IRC §507(b)(2) transfers – are complex and beyond the scope of this paper.

F. Calculation of the termination tax: The termination tax under I.R.C. 507(c) is equal to the lesser of the foundation’s “aggregate tax benefit” (i.e., all tax benefits accruing to the organization and its contributors) resulting from its I.R.C. § 501(c)(3) status or the net fair market value of its assets. The “aggregate tax benefit” is the sum of four amounts: 1) The aggregate increase in income, estate and gift taxes to substantial contributors if contribution deductions had been disallowed; 2) the aggregate increase in income tax which would have been imposed on the foundation if it had not been exempt from income tax and in the case of a trust, if deductions under I.R.C. § 642(c) had been limited to 20% of the taxable income of the trust; 3) any amounts received by one private foundation from another if a tax is imposed upon the termination; and 4) interest on the increases in tax for each of the increases under 1-3 from the date on which each increase would have been due and payable to the date on which the organization ceases to be a private foundation.
G. Final Filings with IRS:

1. Form 990-PF: For the short tax year in which the foundation is fully liquidated, dissolved, or terminated, you must file a final Form 990-PF. The final return box in the heading of page 1 should be checked yes. In addition, Part VII-B, question 5 (Was there a liquidation, termination, dissolution, or substantial contraction during the year?) should be answered Yes. An attachment including the following must also be part of the return: a statement explaining the termination, a certified copy of any liquidation plan, resolution, etc, a list of the names and addresses of all recipients of assets, and an explanation of the nature and fair market value of assets distributed to each recipient.

2. Letter to EO Division: When a private foundation dissolves or terminates its existence, it should notify the IRS that it will no longer be filing annual returns. To do so, the foundation sends a letter to the Internal Revenue Service, Tax Exempt/Government Entities, Exempt Organizations Determinations Office, PO Box 2508, Cincinnati, OH, 45201.

H. State Termination: Organizations in certain states must notify the state attorney general or other appropriate state office of the organization’s intent to dissolve, liquidate, or terminate. In Texas, a nonprofit corporation files a Certificate of Dissolution to terminate its existence after all of its assets have been distributed. Trusts can be terminated through a resolution adopted by the trustee(s).