# What Keeps You Up at Night (Or What Should) as a Private Foundation Manager?

## Presentation Outline


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I. Introduction/Private Foundations in Context

This outline describes the major considerations in the planning, creation and operation of private foundations. It is intended as an overview of planning considerations and reference outline for the practitioner to help clients define and achieve their philanthropic goals.[1]

II. Formation and Tax Exemption

A. Choice of Form (State Law)

Within the broad rubric of the nonprofit sector only a limited number of organizational forms are eligible for tax-exempt status: (1) charitable trust; (2) nonprofit corporation; (3) unincorporated association; and (4) limited liability company. Each of these types of entities has unique characteristics and considerations. Because the charitable trust and nonprofit corporation are most commonly used for private foundations, they will be discussed first.

1. Charitable Trusts: Charitable trusts are the oldest type of nonprofit entity tracing their roots back to the Statute of Charitable Uses of 1601. 43 Elizabeth, Chapter 4 (England 1601). A charitable trust is created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust. Charitable trusts created in Texas are governed by the Texas Trust Code as well as common law relating to trusts and are subject to the oversight authority of the Texas Attorney General. Aside from the benefit of having many years of established case law, many organizers choose charitable trusts as the organizational form of their entity because of the rigidity of trusts. A settlor is able to establish the trust with specific purposes and be assured that the trust will operate for those purposes absent court intervention. The settlor also has the security of knowing the trustee(s) will be held to a stricter application of fiduciary standards in performing his or her duties.

   While the rigidity of trusts can be viewed as a benefit, that same feature may be viewed as inflexibility and thus may be viewed as a detriment to others looking to choose an entity. The ability to modify a trust requires court intervention and is not automatic. Trustees must follow different rules as to their investments as well as their ability to delegate duties. Trustees are additionally subject to more stringent conflict of interest and self-dealing prohibitions and must meet a higher standard for indemnification as compared to directors of unincorporated associations or nonprofit corporations.

2. Nonprofit Corporations: Perhaps the most commonly used entity for exemption under Section 501(c) is a nonprofit corporation. Nonprofit corporations in Texas are

[1] Because the authors are Texas practitioners, Texas law is used for all state law discussions.

governed by Chapter 22 of the BOC. See Tex. Bus. Orgs. Code Ann § 22.001 et. seq. The BOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation. See id. at § 22.001(5). It is helpful to note here that income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered. Nonprofit corporations in Texas may be organized for any lawful purpose, but keep in mind that to qualify for recognition of exemption the corporation must be organized with an appropriate purpose identified (e.g. religious, charitable, educational, etc. for Section 501(c)(3) organizations). Pursuant to Chapters 2 and 22 of the BOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes. See Tex. Bus. Orgs. Code Ann. §§ 2.001-002, 2.101-102, 3.003 and 22.054. While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. Whereas unincorporated associations lack extensive statutory guidelines and case law guidance, nonprofit corporations in Texas have Chapter 22 and its predecessor, the Texas Non-Profit Corporation Act, with extensive case law interpreting it, as well as the ability to analogize to for profit corporate law.

There are few drawbacks to organizing as a nonprofit corporation, particularly when the organization will be seeking federal tax exemption under Section 501(c)(3). While establishing and maintaining a nonprofit corporation does require more work (and therefore more expense) as compared to an unincorporated association, the same work will have to be done for an unincorporated association in the event that it is seeking federal tax exemption. Furthermore, while a nonprofit corporation is subject to the Texas franchise tax, certain federal exemptions (including under Sections 501(c)(3) and 501(c)(4)) qualify the organization for exemption from the franchise tax as well. Finally, many of the various rules that are required for nonprofit corporations applying for exemption (such as specific dissolution clauses and the like under Section 501(c)(3)) are a requirement for any organization seeking exemption. Absent specific circumstances such as an organizer wishing to set up a Section 501(c)(3) entity as a charitable trust to take advantage of the specific characteristics and benefits of such an entity, it is generally most beneficial to organize as a nonprofit corporation.

3. Nonprofit Unincorporated Associations: Unincorporated associations are the default nonprofit organization in Texas. Texas defines a nonprofit unincorporated association as an unincorporated organization, other than one created by a trust,

consisting of three or more members joined by mutual consent for a common, nonprofit purpose. See Tex. Bus. Orgs. Code Ann. § 252.001 et seq. Formation of an unincorporated association is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws. The existence of an unincorporated association in Texas is governed by Chapter 252 of the Texas Business Organizations Code ("BOC"). That chapter clarifies that an unincorporated association is a separate legal entity from its members with powers to promote the aims and purposes of the organization and advance the members interests by all legitimate and legal means. Unincorporated associations have the right to sue or be sued, sue or be sued by a member, acquire, hold, encumber, transfer real or personal property without the need for trustees, be a beneficiary of a trust, contract, will, or policy of life insurance, apply for property tax exemption, and apply for federal tax exemption under Section 501(c)(3) or another section. The IRS has acknowledged that a typical nonprofit unincorporated association will be treated as a corporation when it is formed under a contract or bylaws and has elective officers empowered to act for the association. It should be noted that the IRS will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status. These provisions will be discussed more fully below.

Benefits of operating as an unincorporated association relate primarily to the informal nature of such an entity. Unincorporated associations are relatively quick and easy to establish and are internally as flexible as the founder's desire. Finally, unincorporated associations have the ability to rely on statutory authority in Texas to assure that they are recognized as separate legal entities such that members do not have personal liability in tort or contract absent special circumstances.

On the contrary, there are numerous drawbacks to organizing as an unincorporated association. First and foremost, while Texas has adopted Chapter 252 of the BOC (which was derived from the Uniform Unincorporated Nonprofit Association Act, only in place since 1995), there is little case law interpreting either Chapter 252 or its predecessor act, leaving an element of the unknown. Second, because unincorporated associations are so flexible, a founder has less assurance that his or her wishes as to the direction and purposes of the organization will remain unchanged. Many unincorporated associations find they have trouble with potential lenders who are more comfortable dealing with corporations than with unincorporated associations. Finally, choice of law concerns exist where an unincorporated association acts outside Texas as not all states recognize such an entity. Practically speaking, for an unincorporated association to qualify for federal tax exemption under Section 501(c)(3) the unincorporated association must make itself look and act quite a bit like a nonprofit corporation through adoption of a governing instrument with the requisite provisions for exemption thereby lessening the benefits discussed above.

4. Considerations in Choosing the Form: The 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. A corporation is generally the preferred entity for the charitable organization as it provides greater 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. On the other hand, a trust does not have to hold annual meetings, adopt Bylaws or comply with state enacted not-for-profit statutes as does a corporation.

5. Certificate of Formation/Declaration of Trust:

   a) Within the statement of the organization's purpose, the organization must define its charitable, educational or similar charitable purpose.

   b) 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.

   c) Statement that no part of the corporation's activities shall consist of attempts to influence legislation and that it shall not participate in political campaigns.

   d) Statement that the corporation will comply with the requirements of I.R.C. §§ 4941 through 4945 (discussed below).

B. Requirements for Tax Exemption

To be eligible for recognition of exemption from federal income tax, an organization must satisfy the requirements for the applicable exemption classification. With respect to Section 501(c)(3), an organization must have a proper organizational structure (as addressed above), and must be organized and operated exclusively for charitable purposes. See Reg. 1.501(c)(3)-1(a). Pursuant to Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities which are not in furtherance of one or more exempt purposes. To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose. See Reg. 1.501(c)(3)-1(b)(4). Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose. With respect to the operational test, Section 1.501(c)(3)-1(c)(1) of the Regulations provides that "[a]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3)." In other words, "exclusively" means "primarily"; however, a single nonexempt purpose if substantial in nature, is enough to destroy exemption. Furthermore, Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that to be organized and operated for one or more exempt purposes the organization must serve a public rather than a private interest. This last requirement is a requirement that no part of the net earnings inures to the benefit of a private individual.

Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes. Finally, case law has appended the foregoing elements with the requirement that an organization must not be volitive of public policy in order to qualify for exempt status.

While the foregoing are the elements for an organization to demonstrate its qualification under Section 501(c)(3), organizations that are not seeking exempt status under such section but are rather seeking exemption under other sections will need to carefully review such other sections to determine the requirements for exemption. By way of example, to be exempt under Section 501(c)(6) (professional organizations, business leagues, chambers of commerce, real estate boards, boards of trade, and professional sports leagues), the organization must be an association of persons having some common business interest, the purpose of the organization must be to promote that common business interest rather than operating for profit, the organization must not engage in a business ordinarily conducted for profit, and the activities of the organization must be directed to the improvement of business conditions of one or more lines of business. Each of the foregoing elements has its own definitional structures. Accordingly, care should be taken when applying for exemption as an "other than 501(c)(3)" organization that consideration is given to the specific elements which must be met for the applicable exempt classification.

C. 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.

D. Categories of Public Charities

1. Traditional Public Charities: 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. Donative Public Charities: 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. Gross Receipts Public Charities: 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. Supporting Organizations: 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";

5. Public Safety Testing Public Charity: 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.

E. Categories 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: If a foundation meets the criteria of I.R.C. §170(b)(1)(A)(vii) and §170(b)(1)(E)(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). Conduit (or pass through) foundations are described as any other foundation (as defined in section 509(a)), which makes qualifying distributions that are treated as distributions out of corpus in an amount equal to 100% of the foundation's contributions it receives 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)(E)(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.

F. Tax Treatment By Donors of Contributions

1. Gifts of Cash and Non-Appreciated Property: For gifts to private non-operating foundations, a donor's 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 other foundations that are treated as public charities for donation purposes (private operation foundations, exempt operating foundations, and conduit 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: For gifts to private non-operating foundations, a donor's income tax deduction is limited to twenty percent (20%) of the donor's adjusted gross income on gifts of appreciated property (as opposed to 30% for gifts of appreciated property to public charities and to other foundations that are treated as public charities for donation purposes). 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. Any excess can be carried forward for the next five years.

3. Itemized Deduction Limitation: Subject to the limitations above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is reduced by the lesser of 80% of the donor's itemized deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's adjusted gross income for that year exceeds that year's adjusted gross income threshold amount.

III. Initial Filing Procedures for Private Foundations

A. Application for Recognition of Exemption Under Section 501(c)(3)

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 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.

3. Substantially Complete Filing: 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:

      i) The signature of an authorized individual;

      ii) The organization’s employer identification number;

      iii) 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.]

      iv) Statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures.

v) 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.

vi) If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;

vii) 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/). Publication 96-1045, Guidelines to Texas Tax Exemptions, available on the website of the Texas Comptroller, provides detailed information as well as statutory references with respect to tax exemptions along with links to the appropriate application forms.

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. If the foundation will operate in another state, the foundation should confirm whether it will have registration requirements in that state.

IV. Tax Issues Unique to Private Foundations

A. Excise Tax on Investment Income (I.R.C. § 4940)

A private foundation is subject to an excise tax of 2% of its net investment income and, unlike the excise taxes listed below, this tax is unavoidable. 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 and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

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:

- 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:

- 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.

  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%.

  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. 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 (e.g., the distribution requirement is based on the foundation's 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.

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 Non-functionally integrated Type III SO's 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. Penalty: 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.

C. 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. Penalty: 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.

D. Jeopardizing Investments (I.R.C. §4944)

1. No Per Se Violations: 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. Because the Regulations are from the early 1970s, many more recent investment vehicles must be considered by analogy. 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 or as a result of a corporate reorganization.

2. Penalty: 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.

3. Program-Related Investments: The term “program-related investment” appears in the Internal Revenue Code at section 4944(c) as an exception to the general prohibition against private foundations investing in such a manner as to jeopardize the carrying out of their exempt purposes. Section 4944(c) provides as follows:

> (c) Exception For Program-Related Investments. – For purposes of this section, investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes.

TREASURY REGULATION Section 53.4944-3 provides additional specificity as to what constitutes a PRI.

> A “program-related investment” is an investment which possesses the following characteristics:
>
> (i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B);
> (ii) No significant purpose of the investment is the production of income or the appreciation of property; and
> (iii) No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes].

As a result of the definitions set forth in the above cited TREASURY REGULATION, PRIs are said to be subject to three tests: (1) the primary purpose test; (2) the no significant investment purpose test; and (3) the no political purpose test.

a. The Primary Purpose Test: Section 53.4944-3(a)(2)(i) provides that an investment is made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) (i.e. charitable or other exempt purposes) if it *significantly furthers* the accomplishment of the private foundation’s exempt activities and if the investment would not have been made *but for* the investment’s relationship to the foundation’s exempt activities.

   A determination of whether the investment significantly furthers the accomplishment of the private foundation’s exempt activities requires an initial examination of the foundation’s own governing documents to determine the scope of the foundation’s exempt purposes (i.e. are those purposes broad—"charitable, religious, and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code," or are those purposes more narrow, such as limiting the exempt purposes to medical research). To understand if a specific investment will significantly further an exempt purpose of the foundation, the beginning point must be what are those purposes of the foundation? After determining the purposes of the foundation, the governing board must determine that the proposed investment is consistent with those purposes. If a proposed investment is consistent with general charitable or other exempt purposes under sections 501(c)(3) and 170(c)(2)(B), but is inconsistent with more restrictive purposes in the foundation's own governing documents, the foundation should either pass on the investment or take steps to expand its purposes.

Determining whether the proposed investment is made to further an exempt purpose should be focused on the exempt purpose (such as relief of the poor and distressed or underprivileged) and not on whether or not the organization that is going to carry out that purpose is itself an exempt organization. Specifically, section 53.4944-3(a)(2)(i) provides that "[f]or purposes of section 4944 and §§ 53.4944-1 through 53.4944-6 the term "purposes described in section 170(c)(2)(B)" shall be treated as including purposes described in section 170(c)(2)(B) whether or not carried out by organizations described in section 170(c)." It is this clarification that allows private foundations to make program-related investments to non-exempt organizations. Put simply, it is not the recipient of the funds that is most significant, but rather the use of the funds and how that use of the funds furthers one or more exempt purposes *of the foundation*.[2] Accordingly, each investment must be separately analyzed to determine that the investment does, in fact, significantly further the foundation's charitable purposes, and that but for such relationship between the investment and the accomplishment of the foundation's exempt activities, the investment would not have been made. Foundations may find it useful to have contemporaneous documentation showing the purposes of the investment and how the investment is intended to further the foundation's exempt purposes. This type of documentation strengthens the foundation's position that the investment would not have been made but for its relationship to the foundation's exempt purposes.

b. No Significant Investment Purpose Test: To qualify an investment as a program-related investment, the private foundation must show that no significant purpose of the investment is the production of income or the

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[2] Appendix A sets out the ten examples provided in the TREASURY REGULATIONS. Nine of the ten examples deal with PRIs made to entities other than public charities.

appreciation of property. Pursuant to the regulations, the IRS will consider it relevant whether investors solely engaged in for profit investment activities would be likely to make the investment on the same terms as the private foundation. *See* TREAS. REGS. § 53.4944-3(a)(2)(iii). Similarly, where a foundation has an investment policy (which prudent foundations should have), analyzing whether such investment policy would allow for the proposed investment with the terms being considered is also a relevant factor in showing that the foundation is making the investment without a significant purpose of producing income or causing the appreciation of property. The regulations point out, however, that the fact that the investment produces income or capital appreciation, even where significant will not, standing alone, be conclusive evidence of a significant purpose involving the production of income or appreciation of property. *See id*. Rather, the analysis is at the front end of the investment, whether the terms (interest rate, risk level, level of security, etc.) would be attractive to for profit investors and commercial lenders.[3]

The majority of PRIs that are the subject of private letter rulings are made as loans or guarantees. These can be, and are, typically made at below-market interest rates thereby allowing the foundation to demonstrate that the loan is one whose terms would not be attractive to for profit investors or commercial lenders. Again, however, the interest rate is not the only factor to be considered. Loans may be made with inadequate security, to recipients with no credit history or poor credit, or with other terms that cause the loan to carry higher risk. In these cases, the foundation can show that the loan would not be attractive to a for profit investor. Where PRIs take other forms (equity investments, loan guarantees, linked deposits, etc.) the terms of the proposed investment must be closely analyzed to determine whether such terms demonstrate a lack of a for profit motive. There are myriad private letter rulings discussing PRIs and considering this second test. Those rulings are not precedential authority, but do provide a helpful look at other situations that the IRS has found to demonstrate a lack of a production of income/appreciation of property motive. Where the investment terms are not clearly outside of the scope of what a for profit investor would consider, a foundation should review such private letter rulings and consider obtaining a private letter ruling or opinion of counsel letter related to this issue.

[3] Because the analysis is done at the front end of the investment, the contemporaneous documentation addressed above regarding the foundation's purposes at the outset can further prove useful in showing that the foundation did not have a significant purpose involving the production of income or the appreciation of property.

While the regulations provide that no significant purpose of the investment is the production of income and appreciation of property, regulations do not prohibit the foundation from making PRIs that produce income or result in the appreciation of property or even making PRIs where the production of income or the appreciation of property is a purpose—it must merely refrain from making such investments where these goals are a *significant* purpose. PRIs are, by definition, not grants. In setting up these types of investments, foundations generally build in interest along with a return of the principal. It is this ability to get a return on investment that makes PRIs an attractive alternative to grants, allowing foundations to recycle their philanthropic dollars over and over again. A foundation is willing to accept terms that would not be acceptable to for profit investors and commercial lenders of the relationship between the investment and the accomplishment of the foundation's exempt purposes. In this way, the foundation is receiving (in the event that there is no default) a monetary return on its investment as well as social return on this same investment.

c. No Political Purpose Test: The final test that must be met for a foundation to demonstrate that an investment qualifies as a program-related investment is a showing that no purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D), such purposes including attempting to influence legislation and participating in, or intervening in political campaigns on behalf of or in opposition to a candidate for elective public office.[4] This is an absolute prohibition for PRIs as compared to a private foundation being allowed to seek to influence legislation so long as it does so to an insubstantial degree.

Satisfaction of this test is most often accomplished through the inclusion of commitments on the part of the recipient or representations and warranties on the part of the recipient that the funds will not be used for such purposes. These types of commitments, representations and warranties can easily be included in loan documentation, guarantee documentation, etc. Where the foundation is making an equity investment, the foundation must take care to obtain a representation that the recipient will not engage in such practices or will otherwise segregate the foundation's funds to ensure that such funds are not used to accomplish such prohibited purposes. Such a representation can be handled in a side agreement which can also serve as a useful place to recite

[4] There is a limited exception related to a PRI recipient appearing before or communicating with legislative body with respect to legislation or proposed legislation of direct interest to the recipient where the expense of engaging in such activities would qualify as a business deduction under section 162 of the Code. However, PRI funds cannot be earmarked for such use.

and memorialize the foundation's purposes in making the PRI at the outset of the investment, showing from the outset that the purpose is furtherance of the foundation's exempt purposes and not production of income or appreciation of property.

d. Changes in Terms: Terms of investments often change over time. This can be true of program-related investments as well. Because the determination of whether an investment qualifies as a PRI is made at the outset of the investment, care should be given as to whether changes in the terms of the investment will cause the investment to cease to qualify as a PRI. Section 53.4944-3(a)(3)(i) answers this question. That section provides that a PRI does not cease to qualify as such "provided the changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property." Where changes are "made in the form or terms of a program-related investment for the prudent protection of the foundation's investment," such changes will not ordinarily cause the investment to no longer qualify as a PRI. *See id*. Where a change is made other than for the prudent protection of the foundation's investment, the foundation should analyze the need for such change and document that the change is made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property. The foundation may wish to obtain a written legal opinion regarding such issue.

If a change is determined to be a "critical change in circumstances," the investment will cease to be program-related. *See id*. As an example of a "critical change of circumstances," the regulations point to an investment that is shown to be serving an illegal purpose or the private purpose of the foundation or its managers; however, these are not the only types of "critical changes" and each proposed change must be independently examined. Where the change is considered a "critical change" which causes the investment to cease to be program-related, the foundation and the foundation managers will be subject to the excise tax on jeopardizing investments unless the investment is terminated within thirty (30) days after the date on which the foundation (or any of its managers) obtains actual knowledge of the critical change in circumstances.

E. 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. Expenditure Responsibility Grants: Grants to the following types of organizations require expenditure responsibility to avoid making a taxable expenditure: §509(a)(3) Non-functionally Type III 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[5]:

        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.

[5] 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.

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 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), (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,

a. members, officers, trustees of the organization,

b. a grantor or substantial contributor to the organization or a member of the family of either, and

c. 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. ER Failings: 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 a qualified tax practicioner, 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. Penalty: 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. Private Operating Foundations

### 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. Assets/Endowment/Support Test:
   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.

VI. Operation 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:

        i) 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.

ii) 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 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:

   i) A copy of any Grant Agreement;

   ii) Reports regarding grant, if any;

   iii) 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:

   i) 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.

   ii) 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:

(i) 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;

(ii) 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,

(iii) 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. Although not mandated, care should be taken to consider adoption of policies appearing on Form 990-PF.

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.

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 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. BOC 22.357 Public Information 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.

3. 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 and/or Existence

A. General Rules

Once an organization is a private foundation, it can only terminate its private foundation status by showing that regulatory supervision is no longer necessary, i.e. by complying with the requirements of Section 507, so that its assets are subject to public supervision, either through the transfer of its assets to a Section 509(a)(1) charity, or by payment of the Section 507 tax.[6] The rule is once a private foundation, always a private foundation,

[6] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.

unless status is terminated under Section 507.[7] The word "termination" as used in Section 507 is a term of art under federal law, as it does not refer to the organization's legal existence, which may continue under state law despite termination under Section 507.

Private foundation status exists independent of an organization's exempt status; thus, for non-exempt charitable and split interest trusts, Code Section 4947 provides that these trusts are treated as organizations described in Section 501(c)(3), and therefore they are subject to both the provisions of Section 509 and Chapter 42.[8] Section 507 applies to non-exempt charitable trusts which are private foundations. Section 507 also generally applies to split interest trusts.[9]

Section 507 covers three ways a private foundation may distribute its assets and terminate its status, and another method in which it may split-up, but the private foundation's status is not terminated.

B. Section 507(a) Termination

Under Section 507(a), a private foundation's status will only be terminated if the organization notifies the Secretary of its intent to terminate (voluntary termination), or if there have been repeated or flagrant violations of the Chapter 42 provisions (involuntary termination). Section 507(c) imposes a tax on each organization whose private foundation status is voluntarily or involuntarily terminated under Section 507(a). The organization must pay the 507(c) tax, less any amount abated under 507(g), or have the entire amount abated under 507(g).[10] The tax imposed is the lesser of: (i) the amount the foundation substantiated by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the tax exempt status of the foundation, or (ii) the value of the net assets of the foundation. The value of the organization's net assets for purposes of Section 507(c) is to be determined at whichever time such value is higher: either the first day action is taken by the foundation which culminates in its ceasing to be a private foundation, or the date it ceases to be a private foundation.[11] Thus, if a foundation voluntarily terminates its status under Section 507(a) and distributes all of its net assets in the process, then it will have no tax to pay under Section 507(c).[12]

Section 1.507-1(b)(1) of the Regulations provides that in order to voluntarily terminate its private foundation status under Section 507(a), the foundation must submit a statement to the Manager of Exempt Organizations Determinations, Tax Exempt and Government

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7 *Id.*
8 IRS Manual 7.26.7., *supra* note 6.
9 *Id.*
10 *Id*.
11 Treas. Reg. § 1.507-7(a).
12 The 507(c) tax does not apply to a 507(b)(1)(A) or 507(b)(2) transfer unless 507(a) becomes applicable. Treas. Reg. § 1.507-4(b).

Entities Division, of its intent to terminate, including a detailed computation of the amount of tax under Section 507(c). Any 507(a)(1) termination does not relieve the foundation or any disqualified person(s) of tax liability under Chapter 42 for acts or failures to act prior to termination, or for additional taxes imposed for failures to correct those acts.[13]

If a private foundation voluntarily terminates its status under 507(a) but continues operation afterwards, it will need to re-apply for recognition of exemption as a 501(c)(3), if it wishes to be treated as exempt.[14]

A transfer of all of the assets of a private foundation or a significant disposition of assets by a private foundation is <u>not</u> deemed to result in the termination of the transferor foundation unless it elects to terminate under 507(a)(1) or is involuntarily terminated under 507(a)(2).[15] For example, if a private foundation transfers all of its assets to one or more other private foundations (or a private foundation and a public charity) pursuant to Section 507(b)(2) and Reg. 1.507-3(c), the transferor foundation is <u>not</u> treated as having voluntarily terminated its private foundation status under 507(a)(1).[16] Also, if a private foundation transfers all of its assets to a Section 509(a)(2) organization, the transferor foundation will continue to be treated as a private foundation. Thus, if a bequest to the foundation is made in a year following the year of the transfer, it will be regarded as having been made to a private foundation and the foundation will be subject to the provisions of Chapter 42 with regards to those funds.[17]

If liability for any tax under Chapter 42 is incurred by the transferor foundation in the process of making such a transfer, the transferee organization may be liable for the payment of those taxes.[18]

A private foundation which transfers all of its net assets away is required to file the annual 990-PF for the taxable year in which that transfer occurs; however, later returns are not required to be filed so long as the foundation has no legal or equitable title in any assets nor engages in any activity subsequent to that year.[19]

C. Section 507(b)(1) Terminations

Two types of termination are available under Section 507(b)(1): distribution of the foundation's net assets to specified public charities, or the conversion to and operation as

[13] Treas. Reg. § 1.507-1(b)(2).
[14] Treas. Reg. § 1.507-1(b)(3).
[15] Treas. Reg. § 1.507-1(b)(7).
[16] Treas. Reg. § 1.507-1(b)(6).
[17] *Id.*
[18] Treas. Reg. § 1.507-1(b)(8).
[19] Treas. Reg. § 1.507-1(b)(9).

a public charity. Foundations terminating their status under 507(b) are not subject to the 507(c) termination tax.

1. Distribution to Public Charity (507(b)(1)(A)):

   Under Section 507(b)(1)(A), a foundation may terminate its status by distributing all of its net assets to one or more organizations described in 170(b)(1)(A) (other than clauses (vii) and (viii)), each of which has been in existence and so qualified for at least 60 calendar months immediately preceding such distribution.[20] Also, the foundation must not have committed any act or failure to act giving rise to liability for tax under Chapter 42, and it must distribute all of its "right, title and interest in and to" all of its net assets in order to qualify for termination under this section.[21]

   A private foundation terminating its status pursuant to Section 507(b)(1)(A) remains subject to the provisions of Chapter 42 until it distributes all of its net assets to the organizations described in Section 507(b)(1)(A).[22] The foundation will only be considered to have distributed all of its net assets within this section if it transfers all of its right, title and interest in and to all of its net assets to one or more organizations referred to in Section 507(b)(1)(A).[23] To fulfill this requirement, the transferor foundation may not impose any material restrictions or conditions which prevent the transferee organization from freely and effectively employing the transferred assets, or the income from those assets, in furtherance of its exempt purposes.[24]

   If a private foundation distributes all of its net assets to public charities pursuant to the requirements of 507(b)(1)(A), the foundation's status is automatically terminated.[25] The foundation is not required to file a notice of termination under Section 507(a)(1); thus, the private foundation can make the distributions without giving advance notice to the IRS of its intent to terminate and is not liable for tax under Section 507(c).[26]

   The qualifying distributees under Section 507(b)(1)(A) include: (i) churches or conventions or associations of churches (170(b)(1)(A)(i)), (ii) schools (170(b)(1)(A)(ii)), (iii) hospitals (170(b)(1)(A)(iii)), (iv) medical research organizations operated in conjunction with a hospital (170(b)(1)(A)(iii)), (v) organizations receiving substantial public support or governmental support and operated for the benefit of a college or university owned or operated by a

[20] I.R.C. § 507(b)(1)(A); Treas. Reg. § 1.507-2(a)(1).
[21] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.
[22] Treas. Reg. § 1.507-2(a)(4).
[23] Treas. Reg. § 1.507-2(a)(7).
[24] Treas. Reg. § 1.507-2(a)(8).
[25] Rev. Rul. 2003-13.
[26] Treas. Reg. §1.507-2(a).

governmental unit (170(b)(1)(A)(iv)), (vi) governmental units described in Code Section 170(c)(1) (170(b)(1)(A)(v)), and (vii) organizations that normally receive a substantial part of their support from the public or government (170(b)(1)(A)(vi)).[27] Also, the distributee organization must have been in existence and have been so described for a continuous period of at least 60 calendar months immediately before the distribution. However, a distributee organization in existence less than 60 months will qualify as a proper distributee if it was formed from the consolidation of two public charities, each of which would have been in existence for 60 months at the time of distribution had they not been consolidated.[28] A private foundation seeking to terminate its status under this section may rely on a final ruling or determination letter issued to a potential distributee organization that such organization is described in Section 170(b)(1)(A)(i) through (vi), unless public notice is given that this classification has been revoked or the grantor has some knowledge of the distributee's classification revocation. If the transferee organization becomes a private foundation within three years from the date of transfer, the transfer will be considered a transfer under Section 507(b)(2) (see below for the rules related to this type of transfer) rather than a 507(b)(1)(A) termination.[29]

However, if a private foundation distributes all of its net assets to one or more Section 509(a)(1) public charities, at least one of which has been in existence for less than 60 continuous calendar months, or to one or more 509(a)(2) or (a)(3) organizations, the private foundation's status is not terminated, unless the foundation gives the notice under Section 507(a)(1).[30] Similarly, if the foundation transfers less than all of its net assets to qualifying distributees under 507(b)(1)(A), it will have not terminated its foundation status pursuant to these provisions, and must follow the notice provisions of 507(a)(1) if it intends to terminate. The submission of a Form 990-PF marked "Final" does not constitute notice of termination of private foundation status under Section 507(a)(1).[31] If the private foundation does not give notice and does not terminate, the foundation is not subject to tax under Section 507(c).[32] If the private foundation chooses to provide notice, thus terminating its status, it is subject to the tax under Section 507(c) on the date notice is given.[33] However, if the foundation has no net assets on the day it provides notice, the tax imposed by Section 507(c) will be zero.[34]

[27] Treas. Reg. §1.507-2(a).
[28] Rev. Rul. 75-289; IRS Rev Manual 7.26.7, *supra* note 21.
[29] Treas. Reg. §1.507-3(e).
[30] Rev. Rul. 2003-13.
[31] Treas. Reg. §1.507-1(b)(1).
[32] Rev. Rul. 2003-13.
[33] *Id.*
[34] *Id.*

2. Operation as Public Charity (507(b)(1)(B)):

   A foundation may also voluntarily terminate its private foundation status by operating as a public charity for 60 months, without incurring the 507(c) termination tax. The foundation must not be found to have engaged in willful, repeated acts or failures to act giving rise to Chapter 42 tax liability, must meet the requirements of Section 509(a)(1), (2) or (3) for a continuous period of 60 calendar months beginning with the first day of the taxable year, and must notify the Service prior to that period it is terminating its private foundation status, according to the notification requirements of Reg. 1.507-2(b)(1)(ii). The organization must satisfy the IRS that immediately after the applicable time period, the organization has complied with the requirements of 509(a)(1), (2) or (3) during that time.

   To accomplish the termination of private foundation status and conversion to a public charity, the organization must change its organizational structure, its operations, the sources of its support, or a combination of these items, in order to meet the requirements of 509(a)(1), (2) or (3) for a continuous period of 60 calendar months. Thus, it is unlikely a foundation which has been divided due to internal conflicts to the point of termination will desire to go through the hassles of converting to a public charity. Rather, the foundation would be better off distributing all of its assets to another exempt organization, whether a public charity and/or other private foundations.[35]

D. Section 507(b)(2) Distribution to Private Foundation

A private foundation may transfer all of its assets to one or more private foundations, who will generally “inherit” the characteristics of the transferor foundation. The transferor foundation may then voluntarily terminate under Section 507(a), by “paying” the 507(c) tax of zero (as the transferor would have zero assets at the date of termination).[36] Another option would be to split the foundation into several foundations, by creating one or more new private foundations, and distributing a portion of the transferor’s assets to those foundations, to effectuate divergent charitable interests or conflict in the foundation’s management.

If a foundation makes a distribution of its assets to another private foundation, as described below, the foundation’s status is <u>not</u> automatically terminated under Section 507(a)(1); rather, the private foundation must give notice under Section 507(a) in order to

[35] To see the complete set of rules related to converting to a public charity, see Reg. 1.507-2.

[36] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.

terminate its status.[37] The transfer must still satisfy the requirements of any applicable provision of Chapter 42.[38]

If a private foundation transfers its assets to another private foundation pursuant to any liquidation, merger, redemption, recapitalization or other organization or adjustment, the transferee foundation is not treated as a newly created organization.[39] This includes any partial liquidation or any other "significant"[40] disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions from current income (i.e. those described in Section 4942).[41] An example of a partial liquidation may be where a private foundation disposes of a substantial portion of its assets, such as ½, to another private foundation in order to effectuate the separation of family or trustee interests. Additionally, if a private foundation transfers all or part of its net assets to a 509(a)(1), (2) or (3) organization(s) and within three years of the date of transfer, one or more of those transferee organizations lose its public charity status and becomes a private foundation, then the transfer of assets is treated as having been a transfer made to a private foundation under Section 507(b)(2) and these rules will be treated as applying from the date on which any transfer was made.[42] A transfer of assets by a private foundation to an entity not described in Code Section 501(c)(3) or treated as described in Code Section 501(c)(3) via Section 4947(a)(1) constitutes a taxable expenditure under Section 4945(d)(5).[43]

The transferee organization is treated as possessing those characteristics of the transferor organization: this includes the aggregate tax benefit of the transferor (with some restrictions) as well as the tax implications of Chapter 42.[44] A transferee foundation which is *not* effectively controlled, directly or indirectly by the same person(s) who effectively control the transferor foundation cannot succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of transfer. If the private foundation incurs liability under Chapter 42 prior to or as a result of making the transfer of assets to one or more private foundations, transferee liability may apply so that each transferee foundation is treated as receiving the transferred assets subject to the liability.[45]

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37 Treas. Reg. § 1.507-3(d).
38 *Id.*
39 I.R.C. § 507(b)(2); Treas. Reg. § 1.507-3(a).
40 "Significant disposition of assets" includes a disposition for a taxable year where the dispositions to a private foundation(s) for that year, and as a part of a series of related transactions in prior years, total to 25% or more of the fair market value of the foundation's net assets at the beginning of the first taxable year in the series of related dispositions. Treas. Reg. § 1.507-3(c).
41 Treas. Reg. § 1.507-3(c).
42 Treas. Reg. § 1.507-3(e).
43 Treas. Reg. § 1.507-3(b).
44 Treas. Reg. § 1.507-3(a).
45 Treas. Reg. § 1.507-3(a)(4).

Any person who is a substantial contributor to the transferor foundation is also treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the $5,000/2% test as to the transferee foundation. This same rule applies if the transferor foundation makes a transfer to multiple transferee foundations: that person will be a substantial contributor as to all transferee foundations.

If a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (as defined in Reg. 1.482-1(a)(3)), directly or indirectly, by the same person(s) which effectively controlled the transferor foundation, for purposes of Chapter 42 and Sections 507 through 509, the transferee foundation is treated as if it is the transferor.[46] If the transfer is made to multiple controlled foundations, then each transferee is to be treated as the transferor in proportion to the portion of the fair market value of the transferor's assets which it received. This rule does not apply to the reporting requirements of the transferor foundation under Sections 6033 and 6043, meaning the transferor foundation must still file a 990-PF for the year it transfers all of its net assets and fulfill its other reporting requirements.

Any private foundation which has disposed of all of its assets must file a final Form 990-PF for that year (which includes compliance with any expenditure responsibility reporting requirements).[47] This applies whether or not the foundation has terminated its private foundation status by giving the Section 507(a) notice.[48] The due date of the return is the 15th day of the fifth month following complete liquidation, dissolution or termination.[49] If the entity remains in existence as a dormant shell, without equitable title to assets and without any activity, it is not required to file returns in later years; however, if it receives new assets or resumes activities, it must resume filing the Form 990-PF for those years. Further, Section 6043 requires the transferor foundation to attach a statement to the Form 990-PF for the year in which it has a liquidation, dissolution or termination.[50] The transferor should attach a certified copy of the liquidation plan or any resolutions, as well as a schedule of the names and addresses of recipients of its assets and an explanation of the nature and fair market value of the assets given to each recipient. If the foundation has terminated its status, it should also check the "Final" box on the first page of the form.[51]

46 Treas. Reg. § 1.507-3(a)(9).
47 Blazek, Jody, "The IRS Provides Good News for Terminating Private Foundations", 14 TXNEXEMPT 171, January/February 2003.
48 *Id.*
49 *Id.*
50 *Id.*
51 *Id.*

## E. State Law Termination

Nonprofit corporations are governed by the BOC in regard to winding up as well as mergers. Charitable trusts are governed by the Texas Trust Code with respect to dissolution or termination. The procedures set forth in the requisite statutes must be followed to affect a winding up/dissolution/merger as the case may be. For example, when winding up a nonprofit corporation under Chapter 22 of the BOC, a resolution to wind up must be adopted. If the corporation has no voting members, the board of directors adopts such resolution. If the corporation has voting members, the resolution must be approved by the members. Because a voluntary winding up and adoption of a plan of distribution is considered a "fundamental action" under the BOC, the vote required by the members is 2/3 of the votes that members present in person or by proxy are entitled to cast or simply the affirmative vote of the majority of directors in office if there are no voting members. See BOC § 22.164. A proposed plan of distribution must receive a like vote. The organization must then pay or make provision for the payment of liabilities and obligations before conveying its assets pursuant to its plan of distribution. Once assets are appropriately conveyed (including following any provisions of the organization's governing documents regarding transfer of assets on dissolution), an officer of the organization must sign and file a certificate of termination.