Private foundations: what should be keeping you up at night?

Building a better working world

Disclaimer

This presentation is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide tax advice to any taxpayer because it does not take into account any specific taxpayer's facts and circumstances.

Disclaimer

- EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the U.S.

-

- Views expressed in this presentation are those of the speakers and are not necessarily those of Ernst & Young LLP.

Presenters

Darren Moore
Shareholder
Bourland, Wall & Wenzel, P.C.
301 Commerce, #1500
Fort Worth, Texas 76102
+1 817 877 1088
dmoore@bwwlaw.com

Kelli Archibald
Senior Manager
Ernst & Young LLP
2 North Central Avenue, #2300
Phoenix, AZ 85004
+1 602 322 3017
kelli.archibald@ey.com

Joanne Flores Moses
Director of Finance
Boettcher Foundation
600 17th Street, #2210 South
Denver, CO 80202-5422
+1 303 534 1937
joanne@boettcherfoundation.org

Introduction

What should be keeping you up at night?

Private foundation rules

- Some rules are straightforward
  - Pay net investment excise tax under section 4940 (see outline p. 12)
  - Make sure you distribute at least 5% each year under section 4942 (see outline, p. 13)
  - Don't get involved in any political activity under section 4945 (see outline, p. 17)
- We are going to focus on the more complex rules and exceptions to those rules in our discussion today.

EY

Agenda

- Self-dealing § 4941
- Taxable expenditures § 4945
- Investment issues-§ 4943, § 4944

Taxes on self-dealing
§ 4941

Self-dealing

- In general, private foundations cannot conduct any transactions with insiders.
- Why?

  Since foundations are closely held, Congress subjected them to more stringent rules in order to prevent abuse
- The rules are not always as simple and straightforward as they could be

Self-dealing – IRC § 4941

- Internal Revenue Code (IRC) 4941 imposes excise taxes with respect to any direct or indirect act of self-dealing between a private foundation and a disqualified person.
- Who does this apply to?
  - It applies to the self-dealer and, in certain cases, the foundation managers.
- What can go wrong?
  - More than one Chapter 42 excise tax can be assessed on the same act.

Self-dealing transactions

What is self-dealing?

- Transactions are described under IRC 4941(d):
  - The sale, exchange or leasing of property
  - The lending of money or other extension of credit
  - The furnishing of goods, services or facilities
  - The payment of compensation or expenses by the foundation to a disqualified person
  - The transfer or use of the foundation's income or assets by or for the benefit of a disqualified person
  - Certain payments to government officials
- **Numerous special rules and exceptions apply.**

Disqualified persons for self-dealing

What is a disqualified person (DP)?

- Substantial contributor
  - A person or entity that has contributed in the aggregate >$5,000 **and** >2% of the total contributions received from inception to the end of the year
- Foundation manager
  - An officer, director, trustee, one with similar duties to those three, or an employee who has authority with respect to the act in question
- Owner of more than 20% of an enterprise that is a substantial contributor
- A member of the family of the officer, director or trustee
- An enterprise in which a DP discussed above owns more than 35% of the total combined voting power
- Certain private foundations (PFs)

Self-dealing

What happens if you have a self-dealing transaction?

- Correct
- Report
  - Self-report on form 4720
  - Also report on form 990-PF, Part VII-B, Question 1
- Pay the tax
  - No abatement available
  - Disqualified person must pay the tax!
  - 10% on disqualified person and possibly 5% on foundation manager(s)

Exceptions to self-dealing

- Furnishing goods, services or facilities by PF to DP on terms available to the general public
- Furnishing goods, services or facilities by DP to PF without charge
- Payment of reasonable compensation/reimbursement to DP for personal services of a professional nature
- Lease of property by DP to PF if without charge
- Loans or other extensions of credit by DP to PF without interest or other charge
- Pledges of money or property by DP to PF
- Certain transactions during the administration of an estate or revocable trust

Self-dealing

How do you avoid it?

- Awareness is the key!
  - Provide orientation and education of board members and foundation directors
  - Keep a detailed record of all the foundation's DPs

EY

Taxes on taxable expenditures § 4945

EY

Taxable Expenditures–§4945

- In general, private foundations give only to public charities.

Taxable expenditures – definition

- A **taxable expenditure** is an amount paid or incurred to:
  - Carry on propaganda or otherwise attempt to influence legislation (*lobbying*)
  - Influence the outcome of any specific public election or to carry on any voter registration drive (*political activity*)
  - Make a grant to an individual for travel, study or similar purposes unless approved in advance by the Internal Revenue Service (IRS)

Taxable expenditures – definition

- A **taxable expenditure** is an amount paid or incurred to:
  - Make a grant to an organization unless such organization is:
    - A public charity (with certain exceptions). Note: there are special rules that apply to supporting organizations
    - An exempt operating foundation

      Or
    - The foundation exercises expenditure responsibility (to be discussed later)
  - Provide grants for non-charitable purposes

EY

Taxes on taxable expenditures

What if a foundation makes a taxable expenditure?

- Correct
- Report
  - Self-report on Form 4720
  - Also report on Form 990-PF, Part VII-B, Question 5
- Pay the excise tax or request abatement
  - Foundation pays the 20% excise tax and the manager could be subject to a 5% tax.

EY

Foreign entity contributions

- Generally, the PF must give to a public charity.
- Four ways to give to foreign organizations:
  - Foreign org receives § 501(c)(3) public charity status determination letter from the IRS.
  - Treaties and executive orders
  - Grantor foundation makes a good-faith determination that the foreign organization would likely qualify as a public charity – “equivalency determination.”
  - The PF exercises “expenditure responsibility.”

Foreign entity contributions – equivalency determination

- An “equivalency determination” can be accomplished by:
  - Obtaining a written opinion

    Or
  - Foundation staff making a reasonable determination of equivalency based on submission of an affidavit and other documents from the potential grantee
- If the grantee is a 501(c)(3) equivalent, but would qualify as a private foundation as opposed to a public charity, the foundation must still exercise expenditure responsibility with regard to the grant.

EY

Foreign entity contributions – expenditure responsibility

This is also used for grants to any non-charitable entity.

- Expenditure responsibility – requires foundation to make all reasonable efforts and establish adequate procedures:
  - To see that the grant is spent only for the purpose for which it is made
  - To obtain full and complete reports from the grantee organization on how the funds are spent
  - To make full and detailed reports on the expenditures to the IRS
- This can be a lot of work and there is no requirement for the foreign entity to comply.

Foreign entity contributions – expenditure responsibility

- Expenditure responsibility requirements:
  - Perform pre-grant inquiry
  - Obtain written agreement
  - Maintain funds in a separate account in certain circumstances
  - Obtain regular (annual) reports
  - Report to the IRS on Form 990-PF

EY

Conduit rules

- PF to PF or PF to controlled entity contributions
  - Taxable expenditure unless the foundation maintains expenditure responsibility (ER)
  - Not a qualifying distribution, unless ER maintained **and** distribution rules are followed
- Foundation managers should be aware of the additional steps required for grants paid to these types of entities.
- Proper documentation and reporting is essential.

Grants to individuals

- Grants to individuals for travel, study or similar purposes are a taxable expenditure, unless:
  - Grant awarded with advance IRS approval
  - Grant is either (1) scholarship at educational institution; (2) nontaxable prize/award or (3) to achieve a specific charitable purpose
- Complex rules apply to company scholarship programs.
- Private foundations must be cautious when granting relief payments.
- Hardship grants to individuals are not taxable expenditures.
  - But must show recipient chosen in nondiscriminatory manner
  - Watch out for grants to DPs

Taxable expenditures – exceptions

- **Exceptions:**
  - See outline starting on page 17

Investment issues

Excess business holdings–§ 4943

- What are excess business holdings?
  - Generally, a private foundation cannot hold >20% interest in a business enterprise

- How is it calculated?
  - It is based on the value of the holdings on the day the foundation's excess holdings were greatest during the year.

- **Why?**
  - To keep your eye on the ball

EY

Excess business holdings rules–§ 4943

- Other exceptions:
  - A functionally related business, i.e., not unrelated business income (UBI) but part of an activity related to the exempt purposes of the organization
  - For purposes of § 4943, “business holdings” do not include 4944(c) “program-related investments” (PRIs)
  - A trade or business, at least 95% of the gross income of which is derived from passive sources
  - UBI activity that results from acquisition indebtedness
  - These are not considered business enterprises for purposes of this section.

EY

Excess business holdings rules–§ 4943

- What business holdings are permitted?
  - 20% or less

- Exception: Foundation may hold 35%, if a third party has effective control of the enterprise
  - PF and DP combined own 35% or less of the voting stock
  - It is established that effective control is in one or more persons that are **not** DP of the PF

- De minimis rule: A foundation will never be considered to have Excess Business Holdings if it owns 2% or less of:
  - Voting stock
  - Value of all shares/classes of stock
- This is regardless of what percentage is held by its DP.

Investment issues

- What happens if you hold too much?
  - Correct
  - Reduce the holdings below 20% or 35% if no control
  - Report
    - Form 4720
    - Form 990-PF, Part VII-B, Question 3
  - Pay the tax

Investment issues

- Why is this important?
  - Your foundation doesn't have any significant investments in a business
  - Do you have any alternative partnership investments?

EY

Excess business holdings – IRC § 4943

Applying rules to tiered partnerships

- Many PFs invest heavily in Alternative Investments that are structured as tiered partnerships.
- Foundation provides a K-1 with ownership of 20% or less and foundation holds no other interests indirectly through DPs – game over/no issue
- Foundation provides a K-1 with ownership greater than 20% – more work:
  - Does it pass the 95% passive income test?
  - What interest does it hold in lower-tier partnerships?

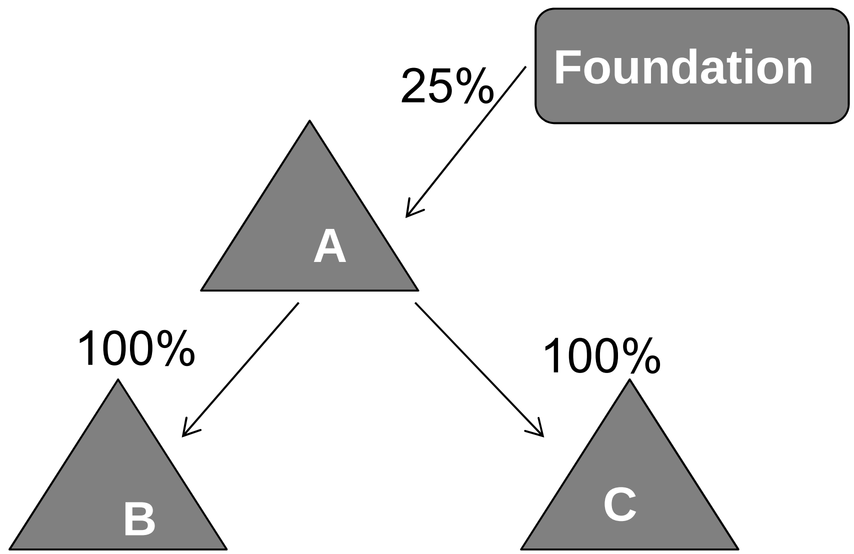
* You may see this occur in the initial year of the investment

EY

Excess business holdings – IRC § 4943

Applying rules to tiered partnerships

- There are two things to consider when partnerships invest in lower-tier partnerships:
  - Determine the proportionate share of ownership in the lower-tier partnership
  - Analyze the income from the lower-tier partnership to determine if it is passive, or trade or business income



EY

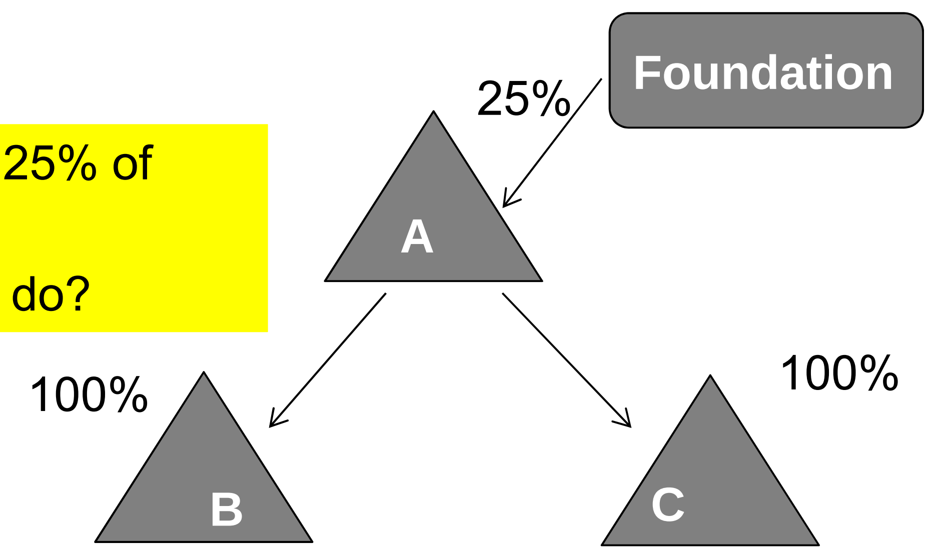
Excess business holdings – IRC § 4943

Applying Rules To Tiered Partnerships

- There are two things to consider when partnerships invest in lower-tier partnerships:
  - Determine the proportionate share of ownership in the lower-tier partnership
  - Analyze the income from the lower-tier partnership to determine if it is passive, or trade or business income

Foundation owns 25% of A,B & C

What do A, B & C do?



EY

Excess business holdings – IRC § 4943

Calculating the proportionate share of ownership in lower-tier partnerships–example:

- PF1 owns 80% of Partnership A. Partnership A owns 10% of Partnership B. What percentage does PF1 own of Partnership B? Assume Partnership A receives all of its income from passive sources. We know that Partnership B operates in a business sector that does not produce passive income. What effect does this situation have on excess business holdings?

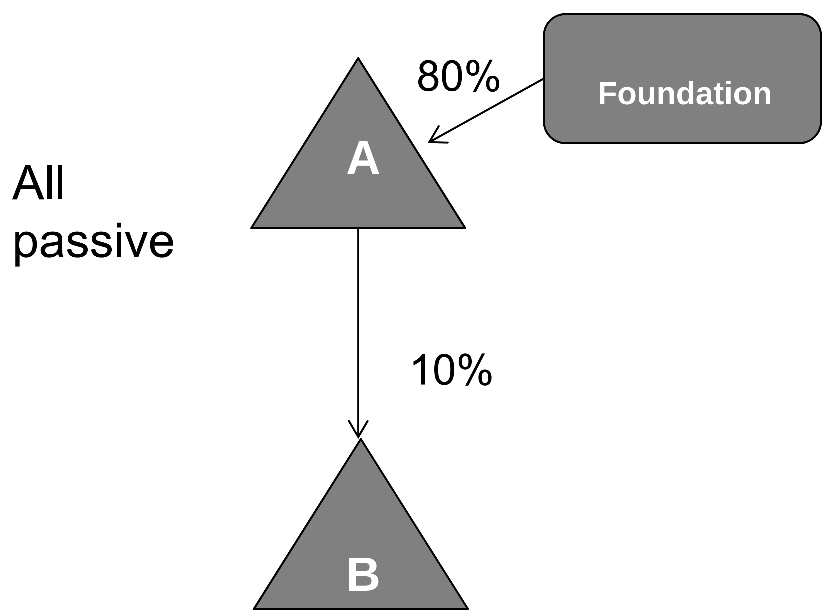
EY

Excess business holdings – IRC § 4943

Calculating the proportionate share of ownership in lower-tier partnerships

- PF1 owns 80% of Partnership A. PF1's proportionate ownership of Partnership B is equal to 80% of 10%. PF1 owns proportionately 8% of Partnership B. Since we know that 100% of the income from Partnership A is passive, then that income falls under the 95% passive rule and therefore the income is not subject to excess business holdings.

- The proportionate 8% ownership in Partnership B would not be subject to excess business holding taxes because that amount falls under the 20% of ownership of voting stock.

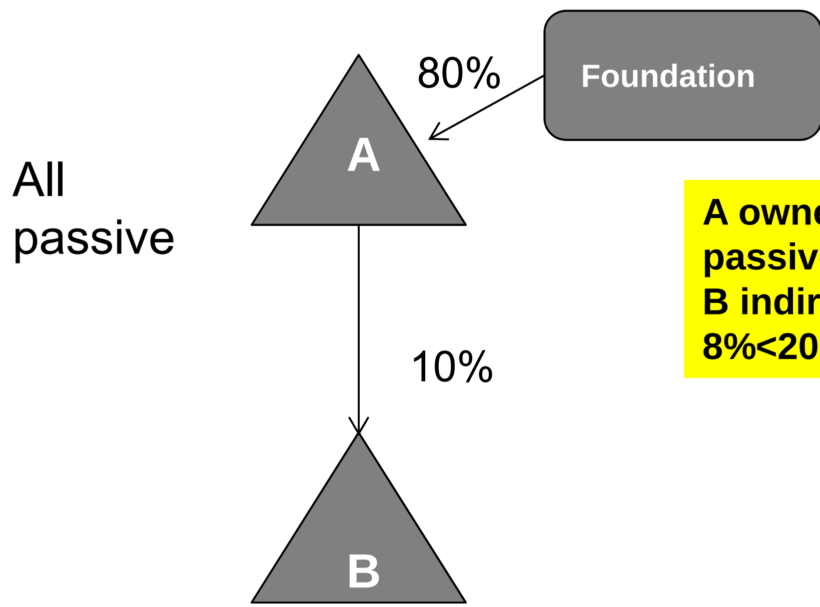


Excess business holdings – IRC § 4943

Calculating the proportionate share of ownership in lower-tier partnerships

- PF1 owns 80% of Partnership A. PF1's proportionate ownership of Partnership B is equal to 80% of 10%. PF1 owns proportionately 8% of Partnership B. Since we know that 100% of the income from Partnership A is passive, then that income falls under the 95% passive rule and therefore the income is not subject to excess business holdings.

- The proportionate 8% ownership in Partnership B would not be subject to excess business holding taxes because that amount falls under the 20% of ownership of voting stock.



A ownership = OK (95% passive exception)
B indirect ownership = OK 8%<20%

Taxes on jeopardizing investments – §4944

- Definition
  - Any amount *invested* in such a manner as to *jeopardize* the accomplishment of exempt purposes
  - Failure of foundation managers to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes
  - Determination of care and prudence made at the time investment is made – no hindsight

EY

Taxes on jeopardizing investments – § 4944

- Definition
  - State issues are of greater concern; the key is to exercise care and prudence when entering into investments.
  - Most relevant is the exception for “program-related investments.”

EY

Taxes on jeopardizing investments – §4944

- Exception for *program-related investment*
  - Not a jeopardizing investment if:
    - Primary purpose is to accomplish one or more of exempt purposes
    - No significant purpose is production of income or appreciation
    - No purpose to influence legislation, or participate or intervene in political campaign

Investment issues

Program-related investments:

- Low-interest loan to developing, minority-owned business
- High-risk investment in low-income housing
- Investment in coffee shop to provide training for rehabilitating drug users for food service industry jobs
- Micro-finance loan programs
- Social Bonds

Questions?