

# **When Giving Money Isn't Enough: Direct Charitable Activities of Private Foundations**

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

**Presented to:  
Salk Institute 2015 Tax Seminar  
La Jolla, California  
May 12, 2015**

The information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein. Nonlawyers are advised to consult an attorney before undertaking issues addressed herein.

All written material contained within this outline is protected by copyright law and may not be reproduced without the express written consent of Bourland, Wall & Wenzel.

© Bourland, Wall & Wenzel, P.C.

**DARREN B. MOORE**

Bourland, Wall & Wenzel, P.C.  
301 Commerce Street  
Fort Worth, Texas

Phone: (817) 877-1088

Email: [dmoore@bwwlaw.com](mailto:dmoore@bwwlaw.com)

Twitter: @darrenbmoore

Blog: [Moorenonprofitlaw.com](http://Moorenonprofitlaw.com)

Darren practices with Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represents individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Darren's practice focuses on representation of nonprofit organizations, in which he advises clients on a wide range of tax and legal compliance issues including organization of various types of nonprofit entities, obtaining and maintaining tax-exempt status, risk management, employment issues, governance, and other business issues. Darren is from Lubbock, Texas and earned a B.A., cum laude, from Texas A&M University, and his J.D., magna cum laude, from Baylor Law School where he served as Editor in Chief of the Baylor Law Review. Darren was admitted to practice law in Texas in 2000 and before the U.S. District Court, Northern District of Texas and U.S. Tax Court in 2001. He is a member of the State Bar of Texas; Tarrant County Bar Association; American Bar Association (Business Law Section, Section of Taxation); College of the State Bar; and is a Fellow of the Texas Bar Foundation. He was named a "Rising Star" by Texas Super Lawyers from 2009-2013. Darren is an adjunct professor at Baylor Law School where he has taught Nonprofit Organizations since 2001. Additionally, he writes and speaks regularly on tax and legal compliance issues.

## TABLE OF CONTENTS

<b>I.</b>	<b>INTRODUCTION.....</b>	<b>1</b>
<b>II.</b>	<b>PRIVATE FOUNDATIONS IN CONTEXT.....</b>	<b>1</b>
<b>III.</b>	<b>DIRECT CHARITABLE ACTIVITIES.....</b>	<b>2</b>
	A. MINIMUM DISTRIBUTION REQUIREMENT AND QUALIFYING DISTRIBUTIONS .....	2
	B. WHO IS ENGAGING IN DIRECT CHARITABLE ACTIVITIES?.....	3
	C. WHAT CONSTITUTES A DIRECT CHARITABLE ACTIVITY? .....	4
	D. REPORTING DIRECT CHARITABLE ACTIVITIES .....	5
<b>IV.</b>	<b>PROGRAM-RELATED INVESTMENTS.....</b>	<b>6</b>
	A. LAW RELATED TO PRIS .....	6
	B. USES OF PROGRAM-RELATED INVESTMENTS .....	10
	C. PROGRAM-RELATED INVESTMENTS AND THE PRIVATE FOUNDATION PROHIBITIONS.....	11
	D. OTHER TREATMENT OF PROGRAM-RELATED INVESTMENTS .....	12
<b>V.</b>	<b>PRIVATE OPERATING FOUNDATIONS.....</b>	<b>14</b>
	A. CHARACTERISTICS OF PRIVATE OPERATING FOUNDATIONS.....	14
	B. QUALIFICATIONS.....	14
	C. ADVANTAGES/DISADVANTAGES .....	17
	D. EXAMPLES .....	18
<b>VI.</b>	<b>USE OF SEPARATE AND SUBSIDIARY ENTITIES FOR RELATED ACTIVITIES ..</b>	<b>18</b>
	A. REASONS TO CONSIDER A SPIN-OFF .....	18
	B. CHOICE OF FORM .....	20
	C. RESPECTING THE SEPARATION .....	22
<b>VII.</b>	<b>CONCLUSION .....</b>	<b>24</b>

## I. INTRODUCTION

According to statistics compiled from the National Center for Charitable Statistics, there are more than 86,000 foundations in the United States with more than 78,000 being classified as independent foundations (i.e. private non-operating foundations that are not corporate foundations).<sup>1</sup> Private non-operating foundations generally do not directly perform charitable programs or services, but rather pursue their charitable purposes through their grant-making activities. In 2013, foundations gave nearly \$55 billion for charitable purposes (approximately \$37 billion came from independent foundations).<sup>2</sup> In the aggregate, grant-making private foundations make hundreds of thousands of grants annually, funding many diverse areas from education and health to arts, the environment, public affairs, religion, and scientific research. However, these broad categories, while garnering the most grant dollars, do not constitute an exclusive list. Rather, grant-making foundations may make grants for any purpose considered exempt under Section 501(c)(3) so long as certain rules of the road are obeyed.

While making an enormous impact through their grant dollars, grant-making foundations have a rich history of going beyond their grant-making programs. There is a subset of private foundations and philanthropists who desire more involvement. They want to leverage their expertise, to supplement their grant-making dollars, and to invest strategically and programmatically. At the same time, these foundations continue to be subject to the prohibited transaction rules set out in the Internal Revenue Code (the “Code”). How will program expenses for charitable activities be treated under the minimum distribution requirement rules of Section 4942? Will a strategic investment into a low-income area of the community at less than fair market rates without security be a jeopardizing investment under Section 4943 of the Code? Is there a better way to structure a foundation who decides to change focus and conduct only charitable activities? If a foundation chooses only to engage in charitable activities, should it create a new entity to put a liability shield between the activities and its endowment? These questions, and others, will be considered in this paper.

## II. PRIVATE FOUNDATIONS IN CONTEXT

The word “foundation” can be deceptive, as it may refer to any number of nonprofit organization types. Section 509(a) of the Code defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) other than the following types of public charities:

1. Organizations that are, by definition or by activity, public charities, I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i)-(v) (“traditional” public charities);
2. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(vi) (“publicly supported charities”);

---

<sup>1</sup> See The Foundation Center, *Key Facts on U.S. Foundations*, 2014.

<sup>2</sup> See *id* (citing *Giving USA Foundation*, Giving USA, 2013).

3. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) (“gross receipts” or “service provider” publicly supported charities);
4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3) (supporting organizations); and
5. Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4).

In other words, a Section 501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above.

### **III. DIRECT CHARITABLE ACTIVITIES**

#### **A. MINIMUM DISTRIBUTION REQUIREMENT AND QUALIFYING DISTRIBUTIONS**

Pursuant to Section 4942 of the Code, a private non-operating foundation must generally distribute at least 5% of the aggregate fair market value of its assets on an annual basis in qualifying distributions.<sup>3</sup> These assets are its investment assets (i.e. those not used in furtherance of the exempt purposes of the foundation, such as the building in which the foundation offices and where its capital equipment and fixtures are located), generally including cash, stocks, bonds, and other investment assets.<sup>4</sup> This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

If a private foundation fails to meet its required payout in qualifying distributions 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.<sup>5</sup> An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made.<sup>6</sup> These penalties can repeat each year thereafter if the required distributions are not made.<sup>7</sup> The penalties apply only to the foundation and not to any foundation manager.<sup>8</sup>

While many foundations think only in terms of grants to public charities as qualifying distributions, the rules are actually much broader. Qualifying distributions also include grants to non-charities for “charitable purposes” (subject to certain restrictions that will be discussed in this paper), costs of all direct charitable activities, amounts paid to acquire assets used directly in

---

<sup>3</sup> IRC § 4942; Reg. § 53.4942(a)-3(a)(2).

<sup>4</sup> Reg. § 53.4942(a)-2(c).

<sup>5</sup> IRC § 4942(a)(1).

<sup>6</sup> IRC § 4942(b).

<sup>7</sup> IRC §§ 4942(a) and (b).

<sup>8</sup> IRC § 4942.

carrying out charitable purposes, certain set-asides, reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation, and certain investments referred to as program-related investments.<sup>9</sup>

## B. WHO IS ENGAGING IN DIRECT CHARITABLE ACTIVITIES?

In addition to the making of program-related investments, a second method of going beyond a standard grant-making program is conducting direct charitable activities. The ability of private non-operating foundations to conduct direct charitable activities (essentially operate a charitable program in a non-operating entity) has been recognized since the Treasury Regulations implementing the private foundation tax regime were first put in place in 1969.<sup>10</sup> Those regulations recognized direct charitable activities ranging from technical assistance for grantees to ensure sustainability and greater impact, to complete research programs seeking to inform public policy.

While spending for direct charitable activities has always been available to private non-operating foundations, the 990-PF has never provided a succinct methodology for reporting direct charitable activities.<sup>11</sup> As a result, the size and extent of a foundation's direct charitable activities cannot truly be ascertained. In 2007, the Foundation Center, a leading authority on philanthropy in existence since 1956, conducted a survey to take a closer look at the direct charitable activities of private foundations.<sup>12</sup> The Foundation Center survey was subsequently summarized in a report (the "Foundation Center Report"), offering a more detailed examination of more than 900 foundations ranked among the top 3,000 foundations in terms of total giving in 2005.<sup>13</sup> Key findings included that a full 25% of those foundations surveyed reported that they do conduct direct charitable activities, with larger foundations (those making grants of \$10 million or more annually) more likely to conduct direct charitable activities (a full 50% of these foundations reported conducting direct charitable activities).<sup>14</sup> Notably, community foundations have significantly higher levels of participation in direct charitable activities (61%) compared to independent foundations (25%) or corporate foundations (16%).<sup>15</sup> While the surveyed foundations reported a number of direct charitable activities, the Foundation Center Report summarized the various activities into three primary types: (1) convening conferences; (2) providing technical assistance to grantees; and (3) supporting staff service on advisory boards of other charities.<sup>16</sup> The common thread among these three primary types of activities is the desire to strengthen the effectiveness of philanthropy through collaboration and capacity building.<sup>17</sup> This is understandable given the numbers above related to the participation of community

---

<sup>9</sup> Reg. § 53.4942(a)-2(c)(3).

<sup>10</sup> IRC § 4942(g)(1)(B); *see also* Foundation Center, *More than Grantmaking: A First Look at Foundations' Direct Charitable Activities* (2007) at 1.

<sup>11</sup> *See* Foundation Center, *supra*, at 1.

<sup>12</sup> *See id.*

<sup>13</sup> *See id.*

<sup>14</sup> *See id.*

<sup>15</sup> *See id.*

<sup>16</sup> *See id.*

<sup>17</sup> *See id.*

foundations, which traditionally have a significant role in capacity building and seeking to build effectiveness in the philanthropic community.

### C. WHAT CONSTITUTES A DIRECT CHARITABLE ACTIVITY?

Given the popularity of direct charitable activities and the availability of direct charitable activities to supplement a foundation's grant-making program, it is worthwhile to consider what constitutes a direct charitable activity that will be considered a qualifying distribution.

While there is no comprehensive list in the Code or regulations, the instructions to Form 990-PF include a number of examples. The Foundation Center Report grouped those examples from the 990-PF instructions into the following groups:

- (1) Convening educational conferences that are not limited to a foundation's own staff/board;
- (2) Providing technical assistance/training to grantees in other charitable organizations;
- (3) Supporting the service of foundation staff on advisory boards of other charities or public commissions;
- (4) Conducting research that goes beyond assessment of potential grants;
- (5) Publishing and disseminating reports on research findings, education, conferences, etc., of broad interest to the public;
- (6) Maintaining facilities used for direct services; and
- (7) Operating direct service programs.<sup>18</sup>

The list above is obviously a non-exhaustive list with significant room for variation from foundation to foundation. For example, the last category listed above (operating direct service programs) could be as broad as any public charity charitable program activity. For example, the author has worked with private non-operating foundations that conduct direct charitable activities, including the creation of a scientific consortium to study a rare neurodegenerative disease with the program involving strategic grant-making coupled with foundation-hosted gatherings for researchers from around the world to present the findings of their research and collaborate together on future work. Other direct charitable activities of this same foundation have included working with consultants, other foundations, and interested parties, along with local school district personnel, to provide "cradle to career" services spanning early childhood education through graduation to improve the lives of at-risk children and, as a result, their local communities. These types of collaborative efforts, where not only funding is provided but also strategic guidance, conferences, and collaborative meetings, are all ways in which a foundation

---

<sup>18</sup> See *id.* at 2-3.

can make qualifying distributions through direct conduct. In each instance, the direct charitable activities complement the grant-making activities of the foundation.

The takeaway from the examples provided is that when a foundation conducts a charitable program using its resources to provide staffing and oversight and direction of the program, it will qualify as a direct charitable activity and be treated as a qualifying distribution.

#### D. REPORTING DIRECT CHARITABLE ACTIVITIES

To understand the reporting of direct charitable activity expenses, it is necessary to understand that qualifying distributions under Section 4942(g) include any amount paid to accomplish one or more purposes described in Section 170(c)(2)(B) [charitable activities] other than any contribution to (1) a controlled organization or (2) a private foundation which is not an operating foundation unless the out of corpus rules are followed.<sup>19</sup> Accordingly, private foundations may include as qualifying distributions amounts paid as direct or indirect charitable expenditures, including expenditures related to direct charitable activities.<sup>20</sup>

Direct expenses are those that can be specifically identified with a particular charitable activity, including (1) compensation and travel expenses of employees and officers in relation to a particular charitable activity, (2) the cost of materials and supplies related to a particular charitable activity, and (3) fees paid to outside firms and individuals related to a particular charitable activity. Indirect expenses are those that are not specifically identifiable with a particular charitable activity, but are nevertheless costs incurred in conducting the charitable activity, including (1) occupancy expenses; (2) supervisory and clerical compensation; (3) repair, rental, and/or maintenance of equipment; and (4) expenses of other departments (such as accounting, personnel, and payroll that serve the department or function that incurs the direct expenses of conducting an exempt activity). In either case, the expenses, if used for both charitable and investment purposes, must be allocated. Regardless of whether such direct and indirect expenses are incurred as a part of a foundation's grant-making program or program of direct charitable activity, such direct and indirect expenses, so long as they are reasonable and necessary to the exempt purpose, will be considered qualifying distributions.<sup>21</sup>

As referenced above, the 990-PF does not provide an easy methodology for clearly reporting the direct charitable activities of a private foundation. As a result, it is easy for the 990-PF to be misconstrued by those reviewing it (including regulators, the media, watchdog groups, or other interested persons), especially with respect to the ratio of administrative costs to grants, not understanding the nature of administrative costs related to direct charitable activities.<sup>22</sup> This results from the fact that the expenses attributable to direct charitable activities

---

<sup>19</sup> IRC § 4942(g)(1).

<sup>20</sup> Reg. 53.4942(a)-3(a)(8).

<sup>21</sup> In addition to the qualifying distributions listed above, other common qualifying distributions are expenses incurred in preparing Form 990-PF, expenses incurred in making Form 990-PF available for public inspection (or making copies), publication of an annual report made available to the public, and even legal fees paid in relation to accomplishment of an exempt purpose.

<sup>22</sup> PriceWaterhouseCoopers LLP, *10 Common Errors to Avoid in Completing a Private Foundation's Form 990-PF*, at 7 (Forum of Regional Associates of Grantmakers 2007).



are included in Part I of the 990-PF but are not broken out separately. While Part IX-A calls for a summary of direct charitable activities, many readers of the Form 990-PF will never get that far. A foundation interested in conveying the benefit and scope of its direct charitable activities may want to provide a type-written cross-reference to Part IX-A, indicating that the amount listed as total operating and administrative expenses at Line 24(d) on the bottom of page 1 includes a set dollar amount of charitable programs conducted directly by the foundation and more fully described at Part IX-A.<sup>23</sup> A foundation may also wish to attach a schedule to its 990-PF providing a detailed explanation of the foundation's expenses for the year.<sup>24</sup> Similar to the way public charities describe their mission and programs on Schedule O, a private foundation may wish to provide more expanded detail on its direct charitable activities. Because a foundation does not solicit funds, it may see little benefit in this; however, for the foundation that wants to highlight its activities, such a detailed description is beneficial.

#### **IV. PROGRAM-RELATED INVESTMENTS**

##### **A. LAW RELATED TO PRIS**

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].

---

<sup>23</sup> See *id.* at 8.

<sup>24</sup> See *id.*

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.

1. *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*. 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.

## 2. *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 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.<sup>25</sup> 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.<sup>26</sup> 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. 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.

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.

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

---

<sup>25</sup> See Reg. § 53.4944-3(a)(2)(iii).

<sup>26</sup> See *id.*

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.

### 3. *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.<sup>27</sup> 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 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.

### 4. *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.<sup>28</sup> 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

---

<sup>27</sup> 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.

<sup>28</sup> Reg. § 53.4944-3(a)(3)(i).

ordinarily cause the investment to no longer qualify as a PRI.<sup>29</sup> 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.<sup>30</sup> 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.

## B. USES OF PROGRAM-RELATED INVESTMENTS

In 2006-2007, approximately 83% of the 494 PRIs surveyed by the Foundation Center consisted of loans, 4.1% were equity investments, and between 1.0 and 1.6% each were business startups/expansion, loan guarantees, cash equivalent deposits, and lines of credit.<sup>31</sup> While these figures represent the majority of PRIs, so long as the investment meets the 3-prong test set forth above, the investment may qualify as a PRI without falling into one of these categories.

PRIs are used for many purposes. They have a unique ability to address areas where the for profit market fails to operate due to lack of financial incentive, for example, PRIs can be used to incentivize for profit companies to create vaccines and medicines in developing countries where the market would not support such activities. Likewise, PRIs are often employed to support economic development in deteriorated urban areas, undeveloped rural areas, or to support businesses owned by economically disadvantaged groups. PRIs can even be used to provide financial support to socially and economically disadvantaged individuals allowing them to go to college or find gainful employment. PRIs are becoming increasingly popular in the context of microfinance allowing foundations to make investments either directly for microfinance or through the use of intermediaries such as MicroCredit Enterprises, a public charity that provides microfinancing to alleviate poverty. In each example, the key is finding an exempt purpose to be accomplished by the investment that is consistent with the foundation's exempt purpose. Where such an exempt purpose can be found and where the parties are willing to structure the investment to meet the other two tests set forth in the Code, PRIs can be a tremendous source of private capital to accomplish socially-beneficial goals.

---

<sup>29</sup> *See id.*

<sup>30</sup> *See id.*

<sup>31</sup> *See* Lawrence, Steven, "Doing Good with Foundation Assets: An Updated Look at Program-Related Investments" (available online at [http://foundationcenter.org/gainknowledge/research/pdf/pri\\_directory\\_excerpt.pdf](http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf)).

## C. PROGRAM-RELATED INVESTMENTS AND THE PRIVATE FOUNDATION PROHIBITIONS

### 1. *Minimum Distribution Requirement*

An investment that qualifies as a program-related investment will be a qualifying distribution as its primary purpose is to accomplish one or more of the purposes set out in Section 170(c)(2)(B).<sup>32</sup> Because program-related investments count as qualifying distributions in the year made and thus count “against” the five percent (5%) requirement, some foundations view this as a “built-in” five percent (5%) return in addition to what other rate of return the foundation generates from the PRI. In other words, if a private foundation makes a \$500,000.00 PRI, that PRI counts as a qualifying distribution in the year made (i.e. it counts as a part of the 5%). Additionally, the PRI reduces the foundation’s asset base upon which the five percent (5%) annual distribution requirement is applied by \$500,000.00 for each year that the PRI is outstanding. Thus if the foundation is earning two percent (2%) interest on a \$500,000.00 loan that is outstanding for five (5) years, the foundation treats the \$500,000.00 as a qualifying distribution in the year made and applies the five percent (5%) payout requirement against the foundation’s assets after the asset base has been reduced by the principal amount over the remaining term of the loan. In the year in which the loan is repaid, there is a “recapture” which operates as an income modification under section 4942(f)(2)(c) of the Code, with the principal repayment effectively being added to the minimum distribution requirement of the year in which the recapture is made.

### 2. *Excess Business Holdings*

Section 4943 of the Code restricts a foundation’s ability to take an ownership interest in a business enterprise above certain permitted holdings to prevent private foundations from having an advantage over other businesses which operate in the taxable income sector. Specifically, a foundation may own twenty percent (20%) of the voting interest in a business enterprise, reduced by the percentage of voting stock held by all disqualified persons.<sup>33</sup> Where the control of the entity can be shown to be held by non-disqualified persons, the foundation and the disqualified persons may own up to thirty-five (35%) of the entity’s voting interest.<sup>34</sup> The foundation may hold a non-voting interest, but only if all disqualified persons together hold no more than twenty percent (20%) of the voting interest or no more than thirty-five percent (35%) of the voting interest if effective control is with a non-disqualified person.<sup>35</sup> The foundation may own a *de minimis* two percent (2%) of the voting stock or value.<sup>36</sup> Section 4943 includes a period of time within which a private foundation must dispose of excess business holdings where such excess business holdings were acquired by gift or bequest.<sup>37</sup> Where a foundation has excess business holdings, it is subject to an excise tax related to same.<sup>38</sup>

---

<sup>32</sup> Cf. Reg. § 53.4944-3 and IRC § 4942(g).

<sup>33</sup> IRC § 4943(c)(2)(A).

<sup>34</sup> IRC § 4943(c)(2)(B).

<sup>35</sup> IRC § 4943(c)(2).

<sup>36</sup> IRC § 4943(c)(2)(C).

<sup>37</sup> Reg. § 53.4943-6.

<sup>38</sup> IRC § 4943(a)(1).



In order to be considered a “business holding” for purposes of the excess business holdings rules, holdings must be of a “business enterprise.” Section 4943(d)(3) provides that the term “business enterprise” does not include a functionally related business or a trade or business at least ninety-five percent (95%) of the gross income of which is derived from passive sources. TREASURY REGULATION Section 53.4943-10(b) further clarifies that “business holdings do not include program-related investments.” Accordingly, whereas foundations are significantly limited in their ability to hold stock of a business enterprise, that limitation does not apply where the investment qualifies as a program-related investment.

### 3. *Jeopardizing Investments*

Private foundations must not make investments which would jeopardize the carrying out of the exempt purpose of the foundation.<sup>39</sup> There is no *per se* type of jeopardizing investment. Rather, the rule requires close scrutiny of the foundation manager’s standard of care, holding such managers to a “prudent investor” standard of care and requiring that care be exercised in the consideration of investments looking to both the long-term and short-term interests of the foundation.<sup>40</sup>

Program-related investments are specifically noted to be an exception to the jeopardizing investment prohibition.<sup>41</sup> In other words, the Code recognizes that investments that qualify as program-related investments (i.e. no significant purpose is the generation of income or appreciation of property) would otherwise constitute jeopardizing investments. Congress made a policy decision to allow foundations to make such investments because these investments are made specifically for the purpose of accomplishing the foundation’s exempt purposes. However, caution is urged to ensure that an investment will qualify as a program-related investment, as failing PRI status, these types of investments would often otherwise constitute jeopardizing investments. For example, an investment that is not on commercial terms and carries significant risk (one that might otherwise qualify as a PRI) that allows for the funds to be used for political intervention (thereby destroying qualification as a PRI) would likely constitute a jeopardizing investment.

## D. OTHER TREATMENT OF PROGRAM-RELATED INVESTMENTS

### 1. *Tax on Net Investment Income*

Pursuant to section 4940(a) of the Code, private non-operating foundations are subject to an excise tax of two percent (2%) on their net investment income.<sup>42</sup> This excise tax on net investment income is not avoidable; however, it can be reduced to one percent (1%) where the foundation can demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the five-year average payout times current year assets, plus

---

<sup>39</sup> IRC § 4944.

<sup>40</sup> Reg. § 53.4944-1(a)(2)(i).

<sup>41</sup> IRC § 4944(c).

<sup>42</sup> IRC § 4940(a).

(b) one percent (1%) of net investment income.<sup>43</sup> Net investment income equals gross investment income (the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties, and income from other sources similar to those in the preceding list) plus net capital gain, minus all ordinary and necessary expenses paid or incurred for the production or collection of such income, including brokerage fees, investment management fees and director fees applicable to managing the investments.<sup>44</sup>

The section 4940 excise tax on net investment income applies to income generated from all investments; there is no exception for income from PRIs. As such, where PRIs generate interest, dividends, rents, royalties, or similar income, such amounts will be subject to the net investment income tax. Additionally, where a PRI is structured as an equity investment and results in capital gains, such gains are also taxable under section 4940 of the Code.<sup>45</sup> Foundations should take note, however, that there is an exclusion from gross investment income from capital gains or losses resulting from property used for a foundation's exempt purposes for at least one year if the entire property is exchanged immediately following such period of use solely for property of like kind which is also to be used primarily for the foundation's exempt purposes.<sup>46</sup>

## 2. *Unrelated Business Taxable Income*

PRIs are not subject to the tax on unrelated business income. Unrelated business taxable income ("UBTI") generally arises in two situations; (1) when the charitable organization has income from an unrelated trade or business; or, (2) when the charitable organization has income incurred with respect to debt-financed property.<sup>47</sup> With respect to the first of these two situations, section 512 provides that "unrelated business taxable income" means gross income that is derived by an organization from an unrelated trade or business which is regularly carried on by the organization less certain allowable deductions.<sup>48</sup> Because the definition requires that the income be generated from an "unrelated trade or business," and because PRIs are, by definition, for the primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from UBTI. With respect to the second situation, section 514(b)(1)(A)(1) excludes from the definition of "debt-financed property" property substantially all the use of which is substantially related to the organization's exempt purposes.<sup>49</sup> Again, because PRIs, by definition, have a primary purpose of furthering one or more of the exempt purposes of the foundation, PRIs are excluded from the definition of debt-financed property.

---

<sup>43</sup> IRC § 4940(e)(2).

<sup>44</sup> IRC § 4940(c)(1); Reg. § 53.4940-1(c).

<sup>45</sup> IRC § 4940(c).

<sup>46</sup> IRC § 4940(c)(4)(1).

<sup>47</sup> IRC §§ 512(a)(1), 514(a)(1)(2).

<sup>48</sup> IRC § 512(a)(1).

<sup>49</sup> IRC § 514(b)(1)(A)(1).



## V. PRIVATE OPERATING FOUNDATIONS

As an alternative (or supplement) to conducting direct charitable activities within a private non-operating foundation, a private operating foundation can be employed. Private operating foundations are not nearly as common as standard non-operating grant-making foundations. Whereas there were 78,582 independent (non-operating) foundations in 2012, there were only 4,218 operating foundations.<sup>50</sup> Total assets of operating foundations stood at \$43.3 billion in 2013 versus \$584 billion for non-operating foundations.<sup>51</sup> However, total giving by private operating foundations was \$6 billion in 2012 (or almost 14% of assets) as compared to \$35.4 billion for non-operating foundations (or approximately 6% of total assets).<sup>52</sup>

### A. CHARACTERISTICS OF PRIVATE OPERATING FOUNDATIONS

A private operating foundation is a non-publicly supported organization that devotes most of its earnings and assets directly to the conduct of its own tax-exempt purposes. As such, it is distinct from a private non-operating foundation in that the standard private foundation is a non-publicly supported charitable organization that has an active grant-making program even where it may also conduct direct charitable activities. A private operating foundation is essentially a cross between a public charity and a private non-operating foundation in that the support feature of the private operating foundation is similar to that of a private foundation (i.e. it is primarily funded from one or very few sources rather than being publicly supported); however, the activities and programs are more akin to that of a public charity. Because of this hybrid-type structure, a private operating foundation is subject to many of the same rules and restrictions applicable to private foundations while also allowing donors to take the higher deductions available to donors who provide gifts to public charities.

### B. QUALIFICATIONS

To qualify as a private operating foundation, the organization must meet an “income test” and in addition one of three alternative tests: (1) an “assets test”, (2) an “endowment test”, or (3) a “support test.” The tests for qualifying as a private operating foundation are based upon the year in question and the three immediately preceding years. These tests may be met on a three out of four year basis or, alternatively, may be met on an aggregate basis.<sup>53</sup>

#### 1. *Income Test*

To satisfy the income test, the organization must distribute substantially all (85% or more) of the *lesser* of its adjusted net income or its minimum investment return directly for the active conduct of activities constituting its charitable, educational, or other similar exempt purposes.<sup>54</sup> The “minimum investment return” is the same as that of the non-operating

---

<sup>50</sup> *Key Facts on U.S. Foundations*, Foundation Center, 2014 at p. 3.

<sup>51</sup> *See id.*

<sup>52</sup> *See id.*

<sup>53</sup> Reg. § 53.4942(b)-3(a).

<sup>54</sup> IRC § 4942(j)(3)(A).

foundation—five percent (5%) of the assets not directly used in carrying out the organization’s exempt function, after subtracting the amount of any acquisition indebtedness with respect to the property.<sup>55</sup> However, because the requirement is “substantially all” (meaning 85%), the payout rate is essentially set at 4.25% of the non-active use assets where the minimum investment return is the lesser of adjusted net income or minimum investment return.

## 2. *Alternative Tests*

### a. Assets Test

The “assets test” requires that substantially more than fifty percent (50%) of the organization’s assets be held for use for the organization’s exempt function activities.<sup>56</sup> “Substantially more” than fifty percent (50%) is defined to mean sixty-five percent (65%) or more.<sup>57</sup> A foundation with program or active-use assets equaling sixty-five percent (65%) or more of its total assets would seek to satisfy the assets test. Foundations satisfying the assets test will generally be foundations with significant property, such as museums holding real property and artwork, camping operations on ranch lands, etc. These otherwise illiquid assets are being used directly for the act of conduct of the foundation’s charitable programs and therefore help the foundation to satisfy the assets test.

### b. Endowment Test

The “endowment test” requires direct distributions of at least two-thirds of the foundation’s minimum investment return (or 3⅓% of its endowment).<sup>58</sup> Note that the payout here may be less than the minimum distribution payout under the income test (3⅓% versus 4.25%) depending upon the foundation’s adjusted net income compared to its minimum investment return and whether the foundation is seeking to satisfy the endowment test. The endowment test will generally apply to foundations holding investment assets amounting to more than thirty-five percent (35%) of total assets, or, stated differently, foundations with less than sixty-five percent (65%) active-use assets. These foundations will generally be service-provider type foundations holding significant investment assets to fund staff salaries and program services, but little in the way of program-use assets. This highlights the flexibility of meeting one of the three alternative tests as such a foundation that subsequently acquires significant real property on which to carry out their programs may, in such instance, seek to use the assets test, where their active-use assets grow in relation to their pure investment assets.

### c. Support Test

For an organization to meet the support test it must draw on support from the general public. The “support test” requires that at least eighty-five percent (85%) of the organization’s support (excluding gross investment income) be from a combination of support from the general public and five or more exempt organizations, not more than twenty-five percent (25%) of

---

<sup>55</sup> IRC § 4942(e).

<sup>56</sup> IRC § 4942(j)(3)(B)(i).

<sup>57</sup> Reg. § 53.4942(b)-2(a)(1)(i).

<sup>58</sup> IRC § 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2(b)(1).

support (other than gross investment income) from any one exempt organization, and not more than fifty percent (50%) of support from gross investment income.<sup>59</sup>

### 3. *Qualifying Distributions*

To satisfy the income test, asset test, and endowment test, it is essential that the private operating foundation focus and spend the requisite amounts on one or more projects in which the private operating foundation is significantly involved in a continuing and sustainable fashion. The Regulations provide a number of examples of “active conduct” programs.<sup>60</sup> Types of programmatic activities conducted by the operating foundations in these examples include surveying and researching problems, making recommendations as to methods for improving the surveyed problems, making grants to entities or individuals engaged in analyzing the problems or acting to remediate the problems, publishing reports, holding seminars, evaluating projects, supervising projects, and like activities. In each case, the operating foundation’s involvement goes beyond merely making a passive grant or loan to a more significant involvement in a program of the foundation.

Treasury Regulation § 53.4942(b)-1(d)(2) speaks to payments made to individual beneficiaries. This section provides that where “a foundation makes or rewards grants, scholarships, or other payments to individual beneficiaries (including program-related investment within the meaning of section 4944(c) made to individuals or corporate enterprises) to support active programs conducted to carry out the foundation’s charitable, educational, or other similar exempt purposes, such grants, scholarships or other payments will be treated as qualifying distributions made directly for the active conduct of exempt activities . . . only if the foundation apart from the making or awarding of the grants, scholarships, or other payments, otherwise maintains some significant involvement . . . in the active programs in support of which such grants, scholarships, or other payments were made or awarded.”<sup>61</sup> This section goes on to state that such determination is to be made on a case by case basis depending on the facts and circumstances of each particular case.<sup>62</sup> The Regulation goes on to provide that a foundation maintains “significant involvement” in a charitable, educational, or other similar exempt activity in connection with which grants, scholarships, or other payments are made or awarded if the foundation is seeking to relieve poverty or human distress through direct programmatic activities or if the foundation has specialized skill and expertise which it puts to use in connection with the making of the grants, scholarships, or other like payments.<sup>63</sup>

---

<sup>59</sup> IRC § 4942(j)(3)(B)(iii); Reg. § 53.4942(b)-1(b)(1).

<sup>60</sup> See Treas. Reg. § 53.4942(b)-1(d).

<sup>61</sup> Treas. Reg. § 53.4942(b)-1(d)(2).

<sup>62</sup> See *id.*

<sup>63</sup> See *id.*

### C. ADVANTAGES/DISADVANTAGES

Advantages of classification as a private operating foundation include the following:

- Operating foundations are eligible to receive qualifying distributions from other private foundations;
- A donor generally may deduct a charitable contribution to an operating foundation to the same extent as contributions to organizations described in IRC 509(a)(1)(2) or (3), for income tax purposes i.e. public charities;
- An operating foundation is not subject to the tax imposed by IRC 4942 on private foundations who fail to comply with the 4942 distribution requirements.<sup>64</sup>

Disadvantages of classification as a private operating foundation include the following:

- Private non-operating foundations have 12 months after the end of their fiscal year to satisfy their payout requirement. However, private operating foundations do not get this extra one-year period, but rather must meet their distribution requirement (the income test and one of the three alternative tests) as of the last day of the year in question or, alternatively, for three out of the four years then ended.<sup>65</sup>
- To continue qualification as a private operating foundation, the foundation must continuously self-sustain its programs (though it may receive funding from outside sources and, in fact, may qualify for the support test). While a foundation or its funders may initially desire this level of significant involvement, that desire may wane over time which will cause the foundation to ultimately sacrifice its private operating foundation status if it ceases to maintain its direct involvement in its programs.<sup>66</sup>
- Unlike a private non-operating foundation that is able to treat both grants and expenditures for direct charitable activities as qualifying distributions, amount paid to other organization as grants are not counted in meeting the distribution requirements under the private operating foundation tests at all. While they can be made, the tests must be met independently of those distributions.<sup>67</sup>

---

<sup>64</sup> Repeated failure to meet the private operating foundation's "payout" requirement will lead to loss of operating foundation status.

<sup>65</sup> See BRUCE R. HOPKINS, JODY BLAZEK, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE, § 3.1(g) (John Wiley & Sons, Inc., 4<sup>th</sup> ed. 2014).

<sup>66</sup> See *id.*

<sup>67</sup> See *id.* at § 3.1(d).

## D. EXAMPLES

The most common type of a private operating foundation is an endowed institution that operates a museum, a library, or some other charitable pursuit. Private operating foundations are often entities created by individuals or families with passions for specific pursuits. In the realm of arts and museums, a common subject for a private operating foundation, examples of private operating foundations include the Frick Collection in New York and the Barnes Foundation in Pennsylvania. Other examples include medical research organizations (such as a physician group self-funding a lab and facilities for medical research), conservation organizations (such as an individual leaving his or her ranch for the study of conservation issues), music education programs for local school districts, etc. Essentially any charitable activity can be handled through a private operating foundation provided the foundation (or its funders) is willing to fund the programs and are willing to maintain direct and active involvement in those programs.

## VI. USE OF SEPARATE AND SUBSIDIARY ENTITIES FOR RELATED ACTIVITIES

### A. REASONS TO CONSIDER A SPIN-OFF

There are many reasons that an existing tax-exempt organization might choose to create an alternative operating structure and/or operate one or more programs through a related or subsidiary organization. Three of the most common reasons are tax concerns, liability concerns, and issues related to management of the program or activity. In the context of private foundations engaging in direct charitable activities, tax concerns do not play as large of a role because the activities are charitable activities that could be carried out inside the foundation itself. To understand this, consider a charitable organization engaging in business operations unrelated to its charitable purpose. Where a Section 501(c)(3) organization engages in unrelated business activities, the organization must take care that it does not negatively impact its exempt status by allowing such unrelated business activities to become substantial.<sup>68</sup> As UBTI grows, the IRS will examine whether an exempt organization's exempt activities are "commensurate in scope" with its financial resources resulting from its business activities. Where the business activities grow so large that they generate revenues that outpace the organization's exempt activities (i.e. the exempt activities and the financial resources are no longer commensurate in scope), the organization risks its exempt status.<sup>69</sup> As a result, an organization may choose to "spin off" one or more unrelated business activities either to a subsidiary organization or a stand-alone organization.

This same concern is not present in the context of a private foundation conducting charitable activities because by their nature those activities may be conducted by the foundation as direct charitable activities. Said differently, there is normally not a tax rationale for spinning off activities that could easily be handled within the foundation from a tax standpoint. The use of "normally" in the preceding sentence is intentional. While unrelated business activities can generate UBTI and potentially risk exempt status, even related business activities can at times prove problematic. Where the related business is undertaken in a way the IRS deems to have a

---

<sup>68</sup> See Reg. § 1.501(c)(3)-1(e)(2).

<sup>69</sup> See Rev. Rul. 64-182.

commercial hue, the organization may risk its exempt status under the Commerciality Doctrine, a non-Code doctrine.<sup>70</sup> Spinning such activities off into a taxable subsidiary avoids this risk.

In addition to spinning off an activity that may be “overly commercial in nature” even though arguably related, a private operating foundation may wish to create a separate entity for the purpose of grant-making. As discussed above, private operating foundations satisfy the private operating foundation qualifications (income test and one of the three alternative tests) by active involvement in charitable activities. Passive grants are not counted at all in the analysis of whether the private operating foundation is able to satisfy the applicable tests. Should a private operating foundation wish to supplement its direct charitable activities with grant-making, it may wish to spin off the grant-making activities into a related private non-operating foundation. However, aside from relatively unique situations, tax reasons will not be the primary motivator for creating separate entities.

Concerns over liability and the potential impact on the organization’s assets are a second, and more significant, motivation for creating a separate organization for private foundations engaging in direct charitable activities. Private non-operating foundations hold significant assets as their endowments. Engaging in direct charitable activities exposes those assets to liabilities to which the assets would not otherwise be exposed. Depending upon the nature of the direct charitable activities, it may be desirable for the foundation to separate those direct charitable activities into a separate or subsidiary organization to create a liability shield between those activities and the foundation’s endowment. This is, of course, dependent upon the nature of the activities. For example, direct charitable activities, such as supporting service of officers and directors on the boards of other organizations, do not present nearly the same liability exposure as running an afterschool program for children. Each foundation must consider its direct charitable activities and its available insurance to cover liabilities associated with those direct charitable activities and make a determination of whether to implement a structure that would create a liability shield to protect the foundation’s endowment. By separating high-risk activities into another entity – a wholly owned subsidiary or otherwise – the tax-exempt organization insulates itself from potential tort and contract liabilities associated with those activities.

Management considerations serve as an additional significant rationale for creating a separate entity to house mission-driven activities. Operating an active business requires focused dedication to the business activities and skill in managing the business operations. That level of focus and specialized skill may not exist on the tax-exempt organization’s board or within its senior management. Even in instances where it does exist, the business activities create the risk of loss of focus and disciplined attention to the organization’s exempt purpose and primary exempt activities. Spinning off the business activities allows each board and management team to focus on the activities of the organization he or she serves, maximizing that organization’s purposes, and to do so consistent with the fiduciary duties owed by the individual to the organization and/or its shareholders. Additionally, depending on the type of subsidiary chosen, it may allow more flexibility in providing executive incentive compensation to attract the most suitable management for the business operations.

---

<sup>70</sup> See, e.g., *Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003); see generally BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, § 4.10 (John Wiley & Sons, Inc., 10<sup>th</sup> ed. 2011).



## B. CHOICE OF FORM

One of the most popular choices for holding direct charitable activities of a private foundation is a single-member limited liability company (“LLC”).<sup>71</sup> The limited liability company was originally enacted as a hybrid entity combining features of corporations and partnerships. It is a single entity in which all of the owners (called members) have liability protection from the operations of the LLC.<sup>72</sup> However, for federal tax purposes, an LLC is treated as a partnership unless an affirmative election is made to be taxed as a corporation *or* unless it has a single member, in which event it is *disregarded* absent an election to be treated as a corporation.<sup>73</sup> As a disregarded entity, it is treated as a division of its tax-exempt parent and therefore does not need to file Form 1023, Application for Recognition Under Section 501(c)(3), and has no independent tax filing requirement on an annual basis. Rather, its income and loss in activities are considered to be a part of the private foundation parent and are reported on the private foundation parent’s Form 990-PF as if those activities have been conducted directly by the private foundation.

While disregarded for federal tax purposes, the LLC is regarded for state law purposes. The result of this is that the LLC provides members and managers liability protection from debts, obligations, and liabilities of the LLC. This liability protection applies even if the members and managers are actively involved in the activities of the LLC. Unlike a limited partnership where a general partner is required, the LLC may be managed directly by its members or managers while still providing the liability shield. This liability protection is a significant benefit of the LLC being used as a subsidiary-type organization, particularly in holding and operating assets that have the potential to be high-risk assets or activities.

In addition to the flexibility created as a result of the disregarded nature of the LLC for federal tax purposes, LLCs, in general, are quite flexible in their operations. While the specific operational aspects of an LLC will be governed by the law of the state under which the LLC is enacted, generally speaking, LLCs require much less with regard to “maintenance” of the entity. For example, under Texas law, LLCs can be member-managed or manager-managed, may choose to have officers or may choose not to have officers, may generally rely on any reasonable method in order to evidence a particular person’s authority to act on behalf of the LLC, are not required to have annual meetings, etc.<sup>74</sup> These attributes cause the LLC to be an attractive form of business, especially for those that desire a lower-maintenance option. Nevertheless, for protection of the separate status necessary to avoid having activities of the subsidiary attributed to the parent tax-exempt organization (discussed more fully below), some level of documentation formality should be followed.

While there are significant benefits to utilizing a single-member LLC, there are concerns that should be considered. First, the foundation should consider in which state it will incorporate

---

<sup>71</sup> For an excellent overview of single-member LLCs in the exempt organizations context, *see generally* Suzanne Ross McDowell and David Shevlin, *Creative and Practical Uses of Single Member LLCs*, American Law Institute, Tax Exempt Organizations: An Advanced Course, Nov. 2013.

<sup>72</sup> *See, e.g.*, Tex. Bus. Orgs. Code § 101.114.

<sup>73</sup> Reg. § 301.7701-2(c)(2).

<sup>74</sup> *See* Tex. Bus. Orgs. Code § 101.001 *et seq.*

the subsidiary LLC. In some states (such as the author's home state of Texas), while the LLC is disregarded for federal tax purposes, it is not disregarded for state tax purposes. As a result, a Texas single-member limited liability company will nevertheless be subject to the Texas franchise tax and sales tax. Furthermore, the applicable statutes in Texas granting property tax exemption and granting limited charitable immunity refer to corporate forms and not limited liability company forms. Each state's laws are different and therefore should be considered. Second, it is unlikely that a private non-operating foundation outside of the private foundation parent would be willing to make a donation or contribution to the single-member LLC of a private non-operating foundation because it will only be a qualifying distribution if out of corpus rules are followed and will be a taxable expenditure unless expenditure responsibility rules are followed. While this may not be a significant issue to the extent the parent private foundation is planning to continue to fund the direct charitable activity on its own, it may be an issue if the parent private foundation desires to have other philanthropic partners join in the funding of the activities. Likewise, while the IRS has confirmed that gifts to a single-member LLC with a tax-exempt parent are deductible, the donor will be limited to the deductions applicable to private non-operating foundations.<sup>75</sup> In comparison to spinning off the activity into a related private operating foundation (addressed below), this poses a limitation.

A second alternative for creating a separate but related organization (whether as a subsidiary or as a sister-type relationship) is to spin off the direct charitable activities into a private operating foundation. The private operating foundation in this instance would typically be formed as a nonprofit corporation.<sup>76</sup> Utilizing this structure provides the benefits of creating a liability shield between the charitable activities and the private non-operating foundation's endowment as well as allowing for focused management of the private operating foundation activities. Additionally, as a private operating foundation, individual donors will not be limited to the lower deductibility limits of private non-operating foundations. Likewise, other private foundations could make qualifying distributions to the private operating foundation. While other private foundations could make qualifying distributions, expenditure responsibility would nevertheless have to be exercised to avoid a taxable expenditure.<sup>77</sup> Finally, as a private operating foundation that has its own recognized exempt status from the IRS, the organization will not have the same concerns regarding qualification for state tax exemptions as addressed above with respect to single-member LLCs that are disregarded for federal income tax purposes.

While there are advantages, as addressed above, to the use of a private operating foundation for conducting the direct charitable activities of a private non-operating foundation, there are also disadvantages. First, the private operating foundation will be required to file Form 1023 and separately apply for tax-exempt status. Furthermore, the private operating foundation will need to file its own Form 990-PF on an annual basis and satisfy the various private operating foundation tests set forth above. Further, distributions from the private non-operating foundation to the private operating foundation (for purposes of providing capitalization or other funding to

---

<sup>75</sup> See Notice 2012-52, 2012-35 IRB 317.

<sup>76</sup> While a nonprofit corporation would be typical, there is nothing that would prevent a private foundation from spinning off the activities into a single-member LLC and having that single-member LLC choose to be regarded and apply for recognition of exemption under Section 501(c)(3) by filing Form 1023; however, in such instance, the LLC is choosing to be treated as a corporation for tax purposes.

<sup>77</sup> IRC § 4945(d)(4).



the private operating foundation) will not count as qualifying distributions as a result of the private operating foundation being controlled by the private non-operating foundation.<sup>78</sup> The only exception to this rule is in the event the out of corpus rules are followed.<sup>79</sup> In that case, the private operating foundation would be required to expend its minimum investment return (as if it were a private non-operating foundation, which will be a different test than the income test and three alternative tests) and additionally spend all of the funds provided by the private non-operating foundation.<sup>80</sup> Effectively, the assets provided from the parent non-operating foundation to the subsidiary operating foundation must flow through and be used in the year given. This may not present an issue if all funds in the private operating foundation are being used on an as-received basis or in the event the private non-operating foundation parent has no need for these distributions to be considered qualifying distributions; however, it is an issue that should be noted. Furthermore, grants from the parent non-operating foundation to the subsidiary/sister operating foundation will be subject to the rules on expenditure responsibility to avoid taxable expenditure status.<sup>81</sup> As a result, the private operating foundation structure is best employed where it will be funded once (or on a non-ongoing basis) with funds that the parent does not need to qualify as qualifying distributions and thereafter agrees to provide reporting to the parent. One final note: to the extent the subsidiary private operating foundation reduces its unrelated business taxable income by making deductible payments of passive income to the parent charitable organization (such as loan repayments), the parent non-operating foundation will be subjected to unrelated business taxable income on such payments.<sup>82</sup>

To the extent the private non-operating foundation will join with others in conducting direct charitable activities, it can utilize a multi-member LLC. Alternatively, it could utilize a private operating foundation with a membership structure having multiple members or without a membership structure but having a board composed of representatives appointed by various interested stakeholders. In either event, the organization will be regarded for federal tax purposes and therefore will need to file Form 1023 as well as an annual Form 990/990-PF. Furthermore, to the extent the subsidiary is controlled (the non-operating foundation parent controls 50% or more of the subsidiary by vote or value), the Section 512 unrelated business taxable income rules discussed above would apply.<sup>83</sup> Likewise, expenditure responsibility would be required if the subsidiary is treated as a private operating foundation (the multi-member LLC may qualify for public charity status depending upon its funding).<sup>84</sup>

### C. RESPECTING THE SEPARATION

Liability insulation is of course dependent on the separation being respected. Regardless of the choice of business entity form used for the subsidiary, it is imperative that the relationship be maintained between the parent and the subsidiary in such a way as to demonstrate the

---

<sup>78</sup> IRC § 4942(g)(1)(A)(ii).

<sup>79</sup> IRC §§ 4942(g)(1)(A)(ii), 4942(g)(3).

<sup>80</sup> *See id.*

<sup>81</sup> IRC § 4945(d)(4).

<sup>82</sup> IRC § 512(b)(13).

<sup>83</sup> *See id.*

<sup>84</sup> IRC § 4945(d)(4).

separateness of the two organizations. This factor can be critical for tax purposes (ensuring that the activities of the subsidiary are not attributed to the parent where the activities would constitute unrelated business) as well as for liability purposes (avoiding having the corporate veil pierced). While state statutory law generally have a high standard for piercing the corporate veil for contractual obligations or liability resulting from contractual obligations (see, for example, Texas Business Organizations Code § 101.002), the standard varies from state to state. Further, the standard often varies where the issue arises in the tort context. Accordingly, tax-exempt organizations looking to establish separate subsidiaries are well-advised to consider the following factors:

1. Transactions between the parent and the subsidiary should be at arm's-length;
2. The exempt organization parent may provide space to the subsidiary; if the subsidiary is tax-exempt, the space may be provided at cost or as a donation, whereas if the subsidiary is a taxable corporation the parent should receive fair market value for the space;
3. The exempt organization parent may furnish intellectual property (including use of the parent's name or mailing lists) either as a capital contribution or through a licensing arrangement (keeping in mind the rules regarding the exception to the general unrelated business capital income rules);
4. The exempt parent may furnish all of the subsidiary's capital as equity contributions (keeping in mind the rules regarding prudent investing for taxable corporations);
5. The parent exempt organization and the subsidiary organization should have separate bank accounts and separate books, avoiding the comingling of funds;
6. 100% overlap of the two boards should be avoided to allow each board to focus on the specific delineated purposes of the organization satisfying his or her fiduciary duties to such organization and to allow independent directors to be in a position to avoid conflict of interest transactions with the other organization;
7. Ideally, officers should not be the same; particularly, one person is not the CEO of both organizations;
8. Officers of the subsidiary should report to the subsidiary's board of directors/board of managers;
9. The subsidiary's board of directors and officers should control the operations of the subsidiary (if the subsidiary is an LLC, this falls to the managers or the member acting in a member-managed organization);
10. With respect to employees, the employees of the parent may provide services to the subsidiary, though such services should be provided pursuant to an arms-length written administrative services agreement that requires reimbursement to

the parent of the cost of such services (note: if the parent makes a profit on this, there could be UBI implications);

11. To the extent employees are working for both organizations, detailed time records must be kept to ensure that each organization is paying its proportionate share of the costs of the employee;
12. The subsidiary should have reasonable capitalization to be able to meet its day-to-day needs and expenses and any liabilities for the actions it is undertaking (including both cash assets as well as other assets of the subsidiary, along with insurance to cover the subsidiary's operations);
13. The organizations should have separate board meetings and keep separate minute books; and
14. The two organizations should seek to make it clear to third parties that the two organizations are separate, which is best accomplished through clarity when signing agreements, letterheads, and business cards that show the separate identities of the two parties.

To accomplish the arm's-length transactions and to document satisfaction of the above factors, the tax-exempt parent and its subsidiary (whether taxable or tax-exempt) should document their relationship through written services agreements, licensing agreements, employee sharing agreements, facility usage agreements, etc. (as may be applicable).

## **VII. CONCLUSION**

Foundations have always been able to engage in direct charitable activities and structure their investments in a way to complement those charitable activities and the foundations' grant-making activities; however, today there is an increased focus on bringing to bear the expertise of foundations, their staff, and their funders into charitable programs to seek the greatest impact. These foundations engage in direct charitable activities—sometimes as investments, sometimes through expenditure of funds within the foundations, and sometimes through operating as (or in partnership with) private operating foundations. An understanding of the Section 4940 prohibited transaction rules and careful planning will allow these foundations to create a legal framework protective of the foundations' endowments but sufficiently flexible to allow the foundations to pursue their charitable missions.