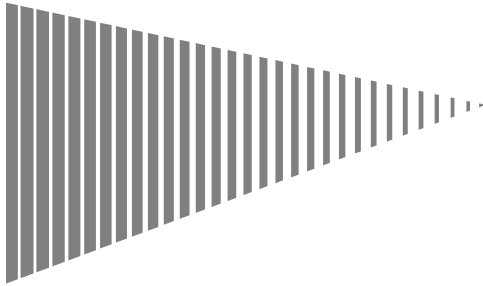
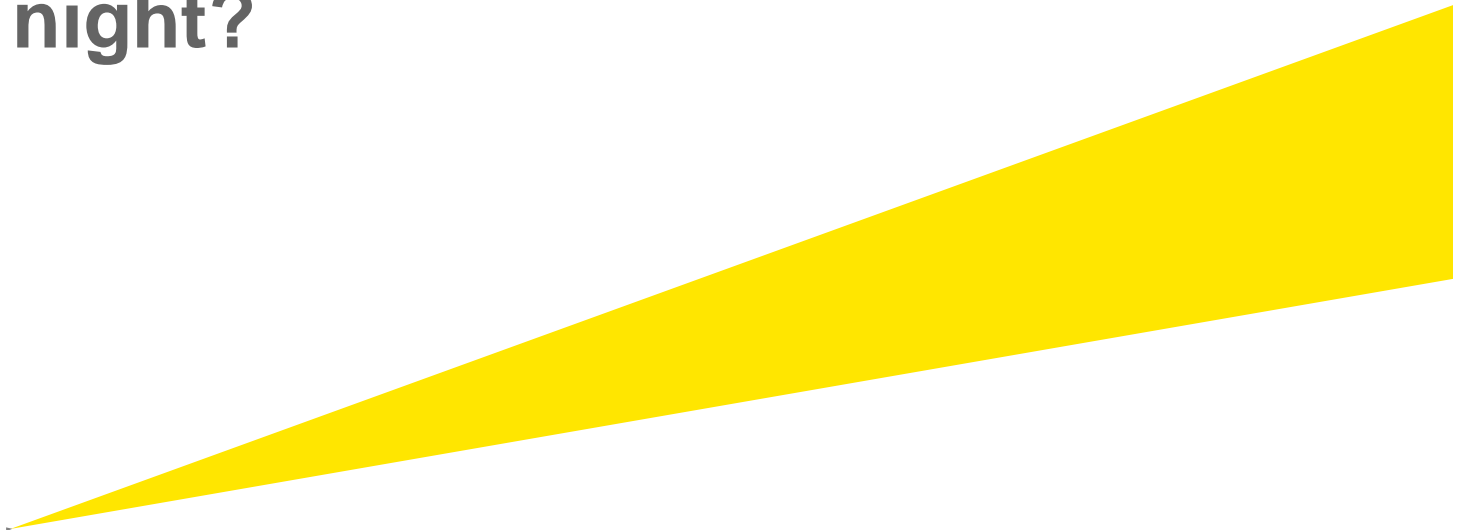


# Private foundations: what should be keeping you up at night?



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# Introduction

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What should be keeping you up at night?

# Private foundation rules

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- ▶ 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.

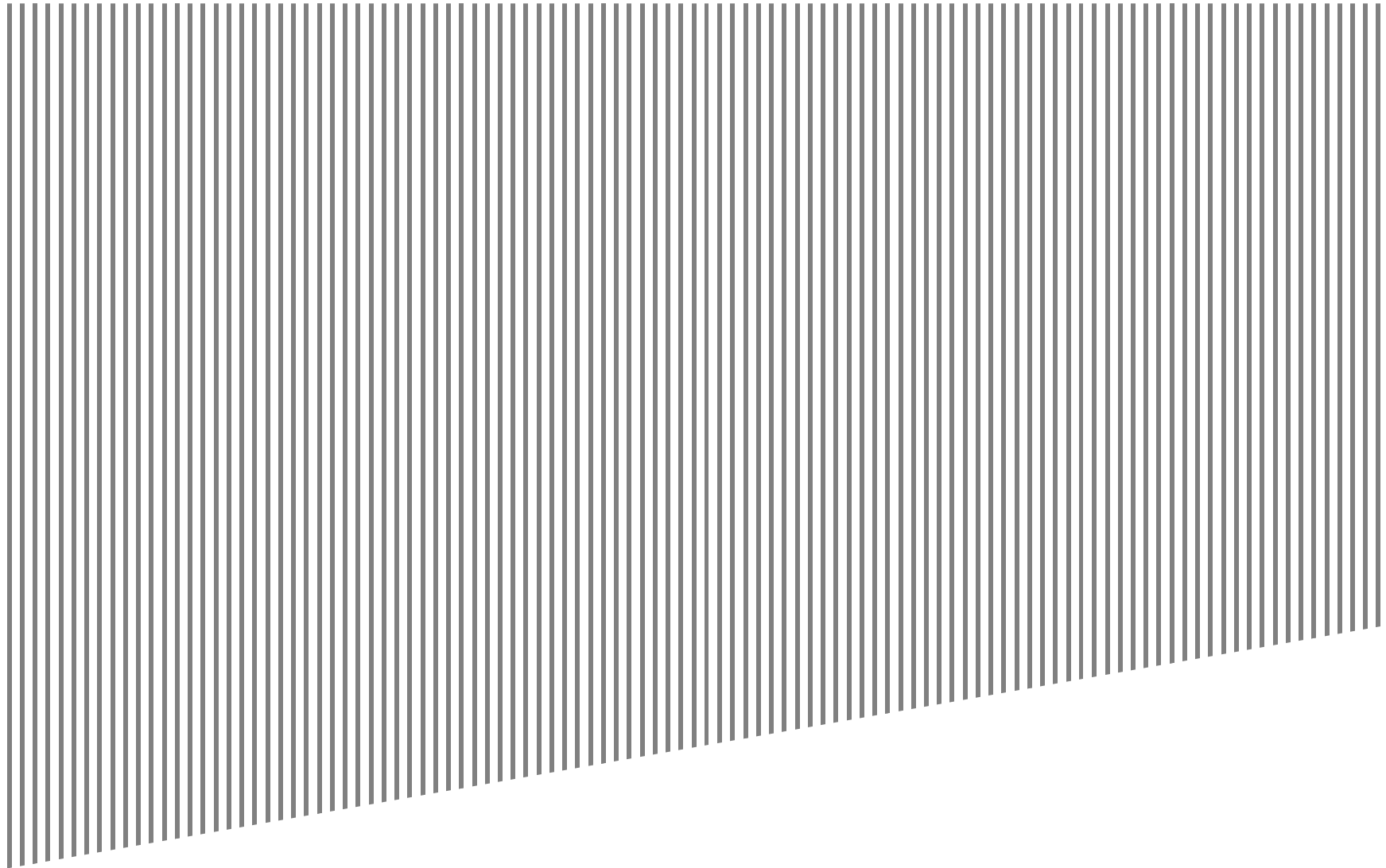
# Agenda

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

# Taxes on self-dealing

## § 4941





# Self-dealing

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- ▶ 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

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- ▶ 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

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## 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

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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

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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

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- ▶ 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

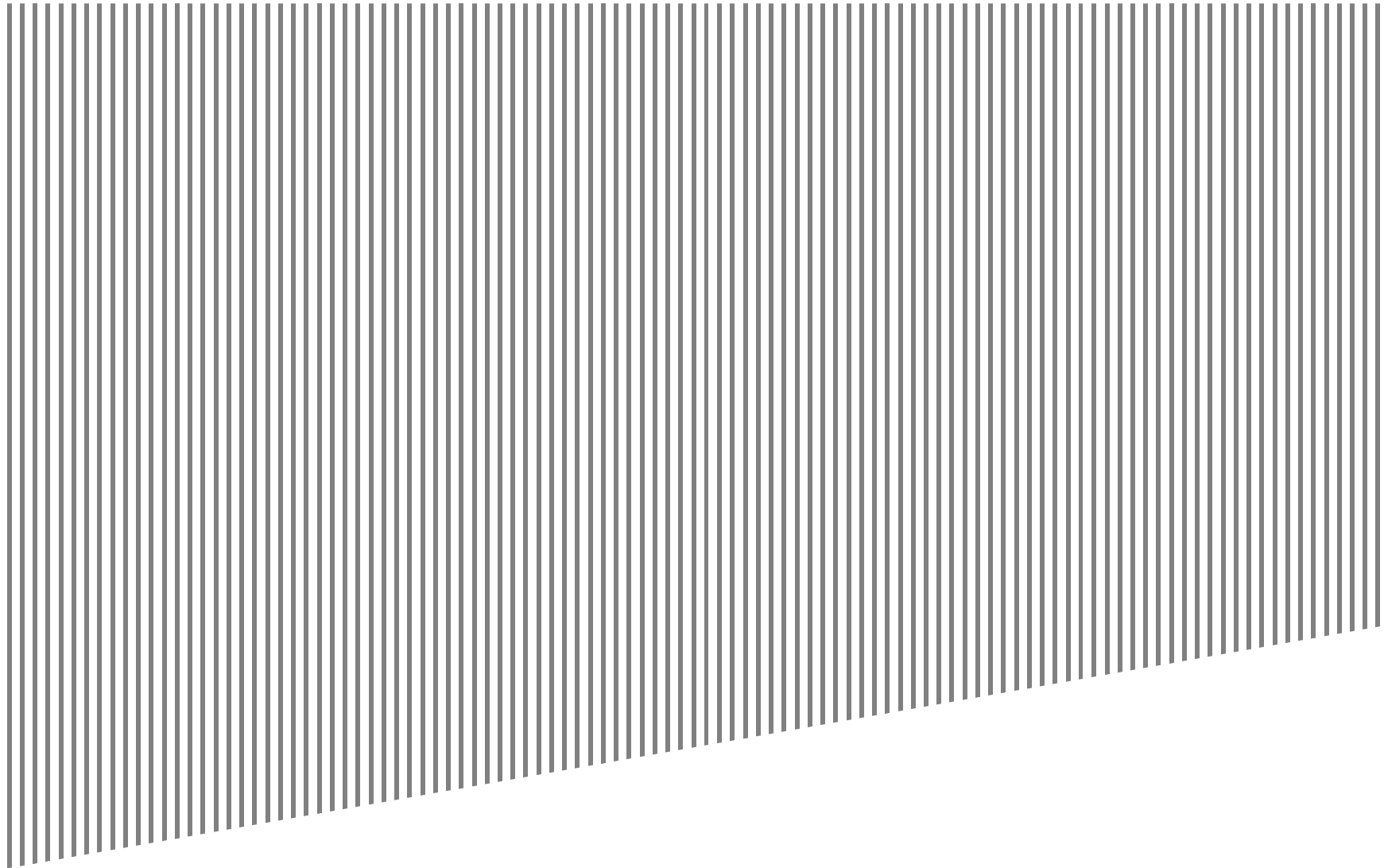
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## How do you avoid it?

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

# Taxes on taxable expenditures

## § 4945





# Taxable Expenditures—§4945

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

# Taxable expenditures – definition

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- ▶ 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

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- ▶ 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

# Taxes on taxable expenditures

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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.

# Foreign entity contributions

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- ▶ 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

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- ▶ 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.

# Foreign entity contributions – expenditure responsibility

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**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

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- ▶ 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



# Conduit rules

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- ▶ 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

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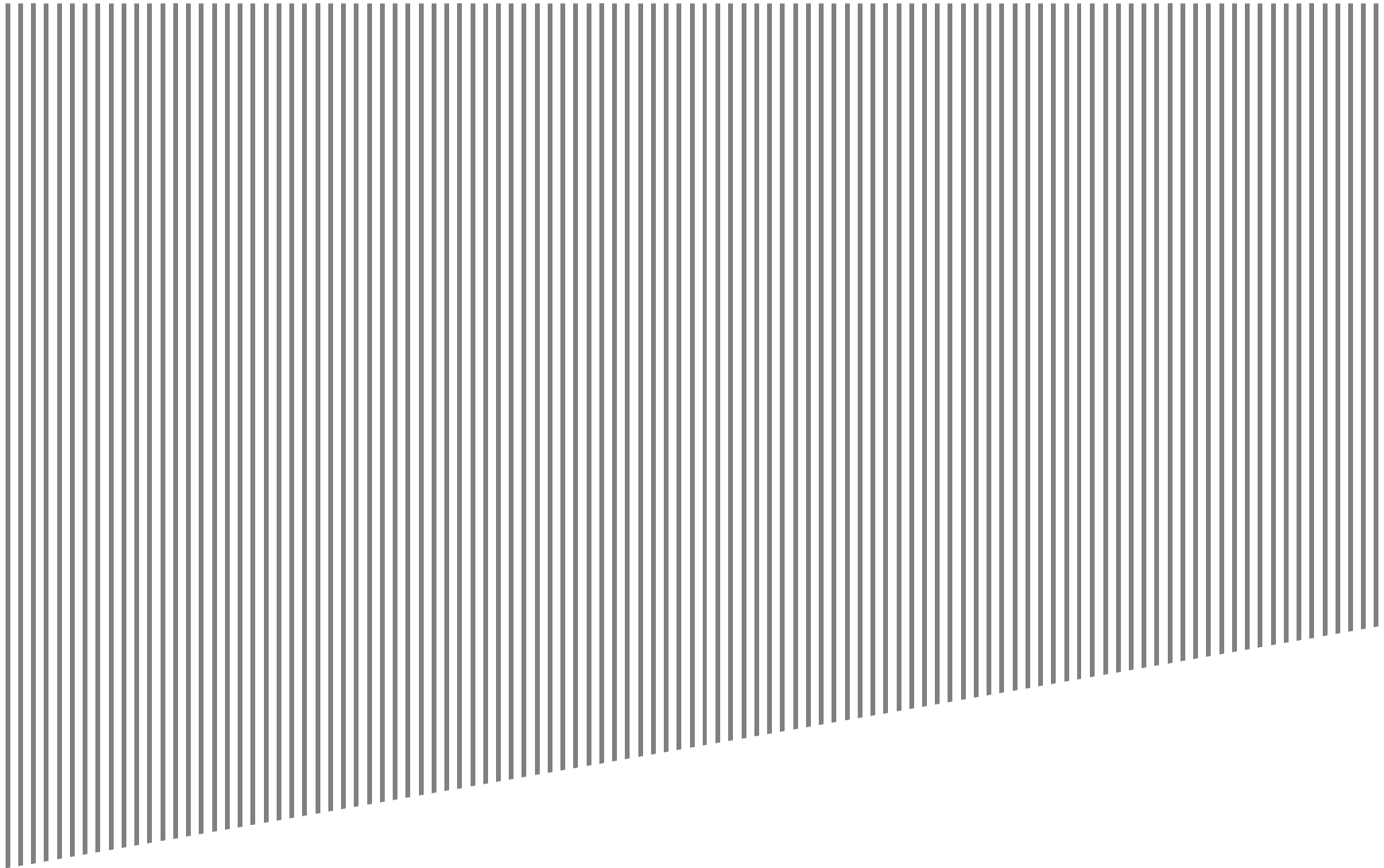
- ▶ Grants to individuals for travel, study or similar purposes are a taxable expenditure, unless:
  - ▶ Grant awarded with advance IRS approval
  - ▶ Grant is either (1) scholarship at educational institution; (2) nontaxable prize/award or (3) to achieve a specific charitable purpose
- ▶ Complex rules 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

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

# Investment issues



# Excess business holdings—§ 4943

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- ▶ 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

# Excess business holdings rules—§ 4943

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- ▶ 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.

# Excess business holdings rules—§ 4943

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- ▶ 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

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- ▶ 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

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

# Excess business holdings – IRC § 4943

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## 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?

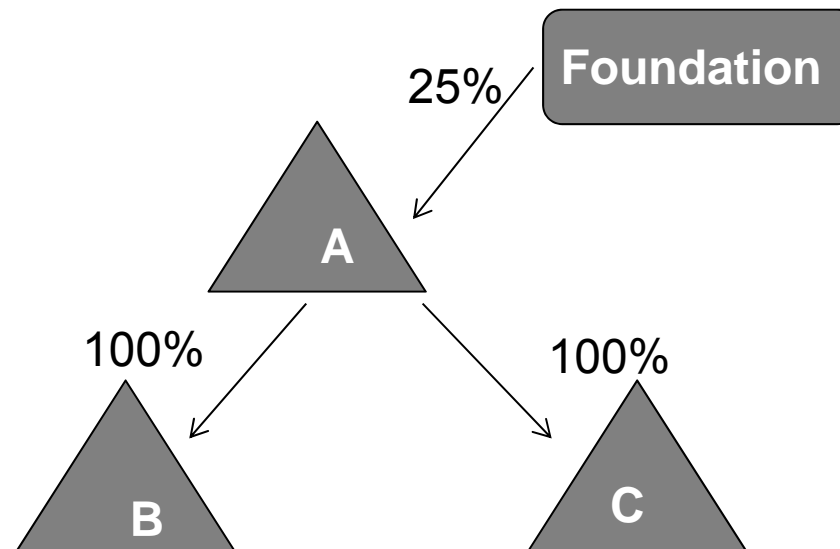
\* You may see this occur in the initial year of the investment

# Excess business holdings – IRC § 4943

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## Applying rules to tiered partnerships

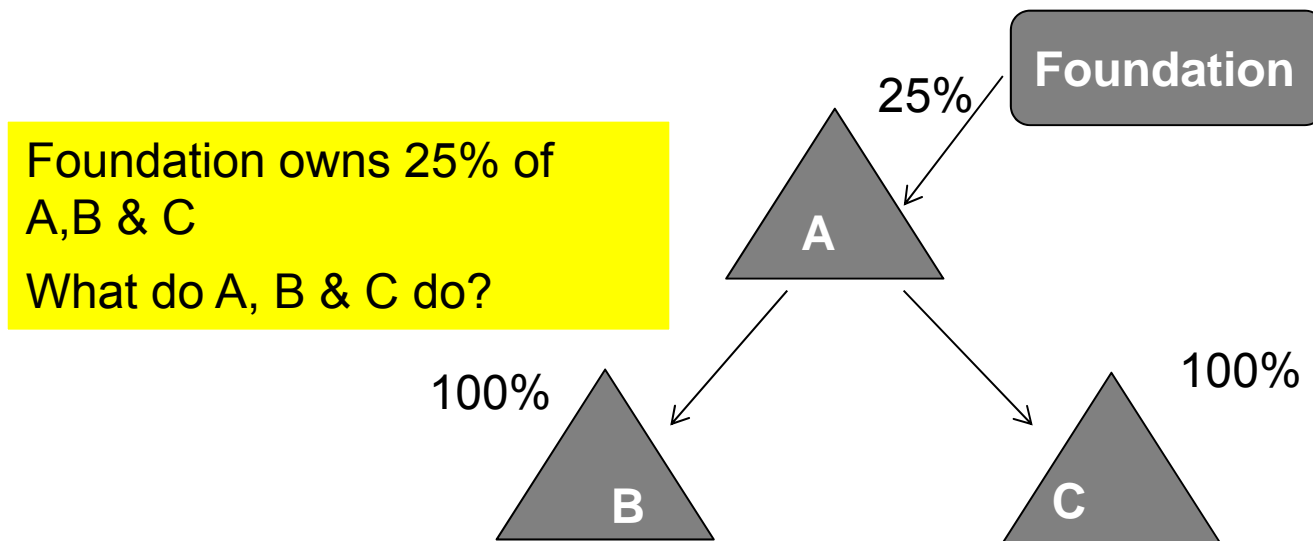
- ▶ There are two things to consider when partnerships invest in lower-tier partnerships:
  - ▶ Determine the proportionate share of ownership in the lower-tier partnership
  - ▶ Analyze the income from the lower-tier partnership to determine if it is passive, or trade or business income



# 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



# Excess business holdings – IRC § 4943

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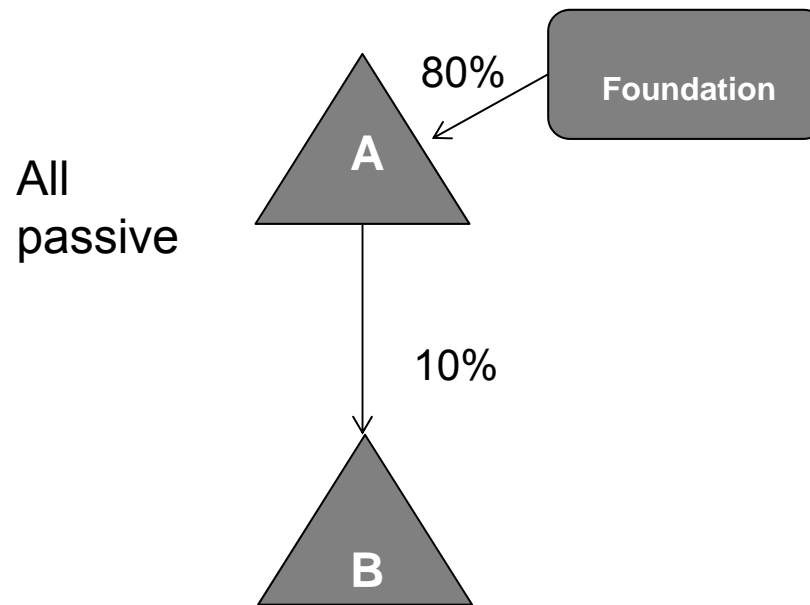
## Calculating the proportionate share of ownership in lower-tier partnerships—example:

- ▶ 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?

# Excess business holdings – IRC § 4943

## Calculating the proportionate share of ownership in lower-tier partnerships

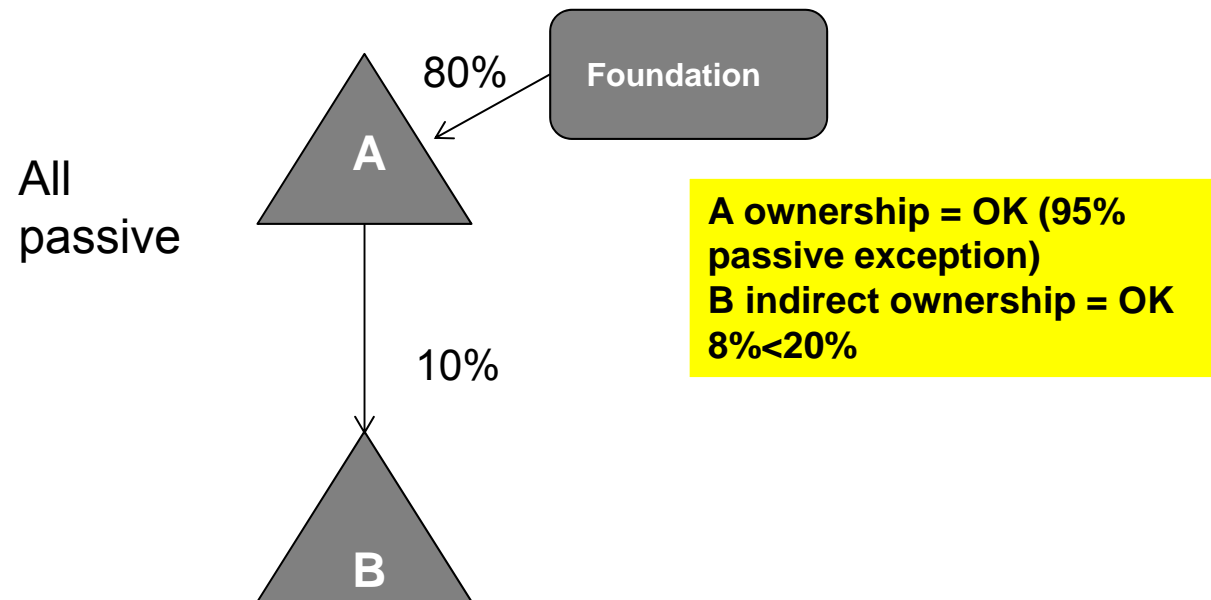
- ▶ PF1 owns 80% of Partnership A. PF1's proportionate ownership of Partnership B is equal to 80% of 10%. PF1 owns proportionately 8% of Partnership B. Since we know that 100% of the income from Partnership A is passive, then that income falls under the 95% passive rule and therefore the income is not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



# Taxes on jeopardizing investments – §4944

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## ▶ 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



# Taxes on jeopardizing investments – § 4944

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## ▶ 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.”

# Taxes on jeopardizing investments – §4944

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- ▶ 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

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## 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?

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