

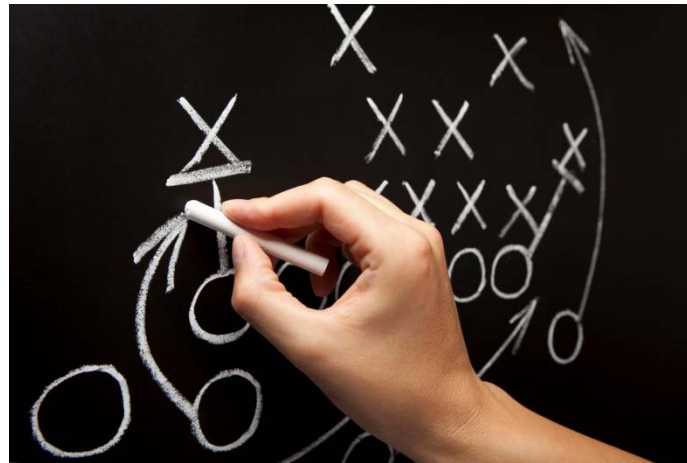
When Giving Money Isn't Enough: Direct Charitable Activities of Private Foundations



Salk Institute 2015 Tax Seminar | May 12, 2015 | La Jolla, California
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Adding to the Foundation Playbook

- ∞ Direct Charitable Activities
- ∞ Program-Related Investments
- ∞ Private Operating Foundations
- ∞ Use of Separate and Subsidiary Entities



Minimum Distribution Requirement

- ∞ §4942 (d)– “*Distributable Amount*”:
 - For any tax year must distribute:
 - *Minimum investment return* (5% of average FMV of non-charitable use assets with adjustments)
 - Less certain taxes
 - Must distribute by end of succeeding tax year

Qualifying Distributions §4942(g)

- ∞ Any amount paid to accomplish exempt purposes (including reasonable and necessary administrative expenses) or acquire assets used or held for use for exempt purposes (as per §170(c)(2)(B))
 - Grants
 - Distributions for charitable purposes
 - Costs of direct charitable activities
 - Amounts paid for charitable use assets
 - Reasonable and necessary administrative expenses
 - Certain set-asides
 - Program-related investments

Failure to Distribute Income - IRC §4942

∞ 1st tier:

- Foundation: 30% on difference of what should have been distributed and what was distributed (i.e. Undistributed Amount)

∞ 2nd tier:

- Foundation: additional 100% of Undistributed Amount if penalty assessed and correction not made

Direct Charitable Activities: What are They?

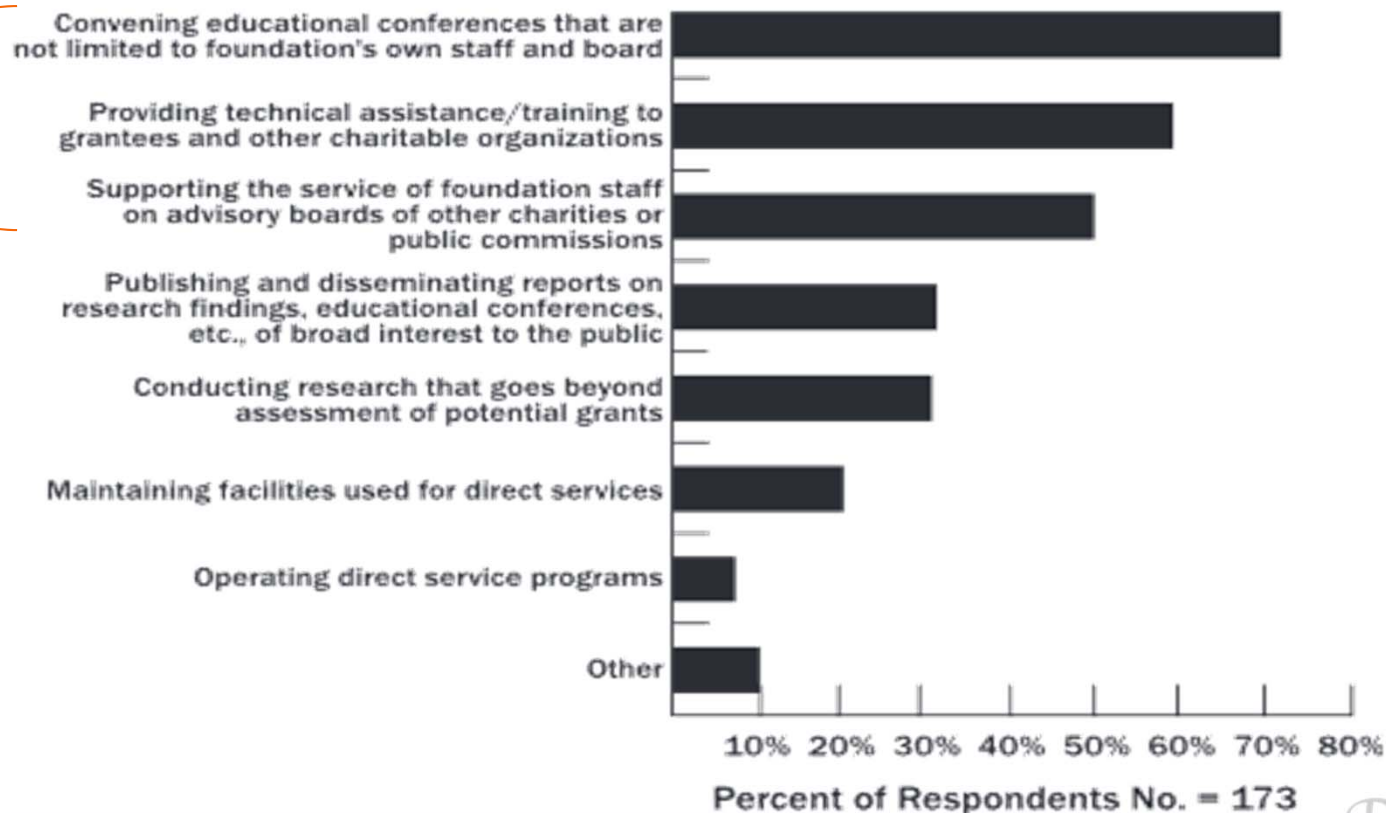
- ✎ Convening educational conferences that are not limited to a foundation's own staff/board
- ✎ Providing technical assistance/training to grantees in other charitable organizations
- ✎ Supporting the service of foundation staff on advisory boards of other charities or public commissions
- ✎ Conducting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

Most Commonly Reported DCAs

FIGURE 2. Types of Direct Charitable Activities for Independent Foundations

What type(s) of direct charitable activities does your foundation engage in?

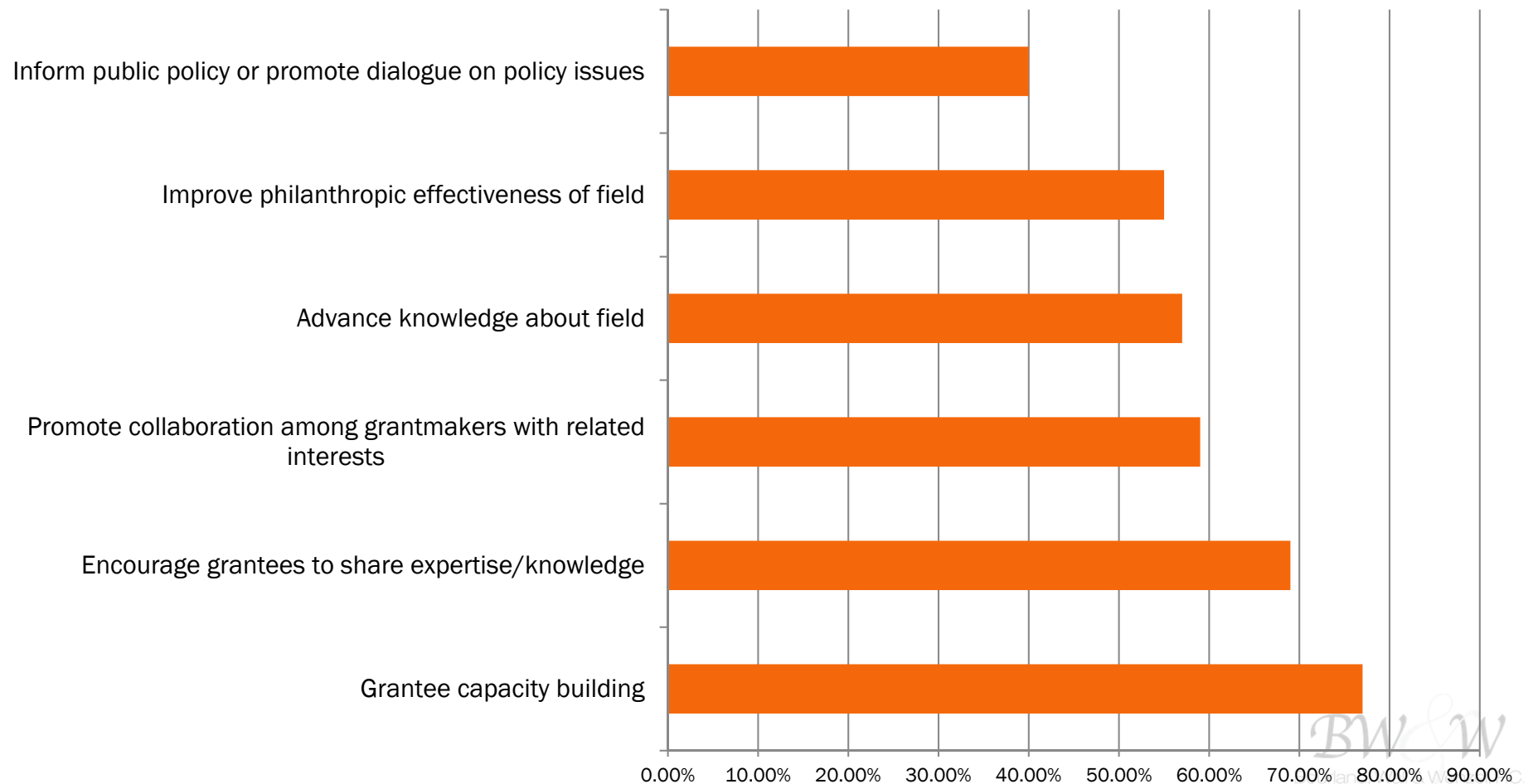
3
primary
types



Source: The Foundation Center, *More Than Grantmaking: A First Look at Foundations' Direct Charitable Activities*, 2007.

Why do Foundations Conduct DCAs?

Percentage of Respondents

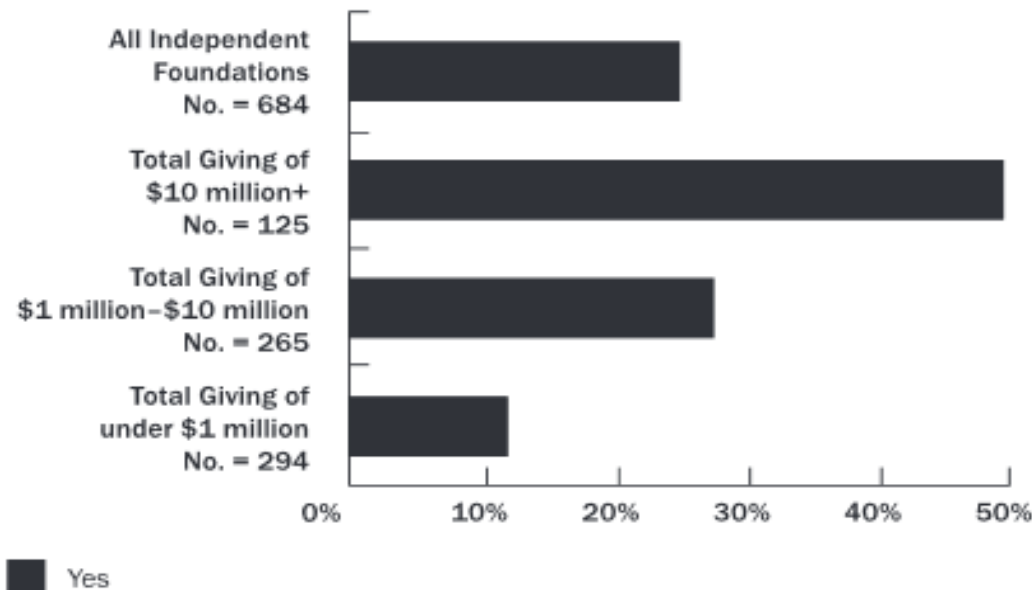


Who Conducts DCAs?

- Foundation Center 2007 survey of 900 foundations ranked among top 3000 in total giving

FIGURE 1. Independent Foundation Engagement in Direct Charitable Activities, by Foundation Size

Does your foundation currently engage in DCAs?



Source: The Foundation Center, *More Than Grantmaking: A First Look at Foundations' Direct Charitable Activities*, 2007.

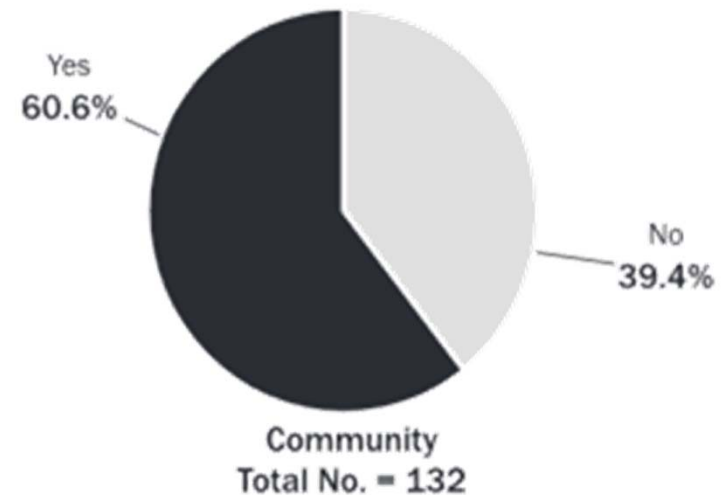
DCAs and Staffing

- ✎ Of the 900 foundations responding to The Foundation Center's survey, 25% have no staff; however, more than 95% of respondents reporting DCAs have paid staff
- ✎ 91% engage staff in DCAs
- ✎ 37% rely on consultants
- ✎ 23% use board members

Note: One category does not exclude others

Community Foundations & DCAs

- Higher levels of providing technical assistance to grantees
- Most common rationale
 - improving the effectiveness of the philanthropic field



Source: The Foundation Center, *More Than Grantmaking: A First Look at Foundations' Direct Charitable Activities*, 2007.

Why PRIs?

- ∞ Provide alternative form of financing for charitable programs
- ∞ Enables recirculation/reinvestment of capital
- ∞ Tool allowing the PF ability to leverage philanthropic dollars

Exception to the Jeopardizing Investments Prohibition

- ✎ The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B)
- ✎ No significant purpose of the investment is the production of income or the appreciation of property
- ✎ No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(B)(2)(D) [political purposes]

The Primary Purpose Test

∞ *Significantly furthers* PF's exempt purposes

- Examine PF's purposes
- Analyze how investment furthers purposes
- Analysis focuses on purposes, not tax status of recipient entity

∞ Investment would not have been made *but for* relationship to PF's exempt purposes

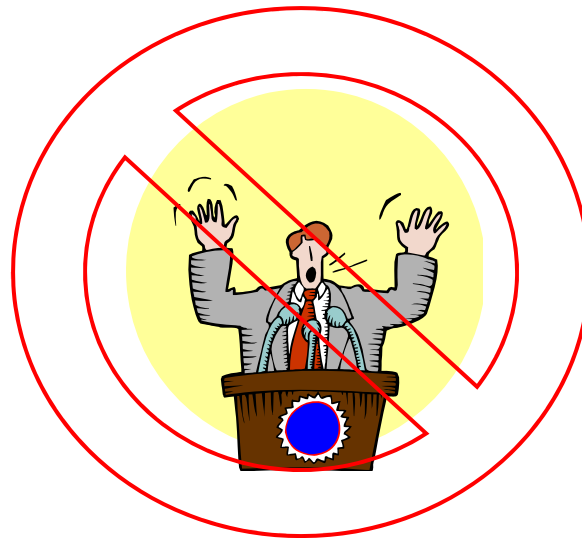
- Provide contemporaneous documentation of due diligence

No Significant Investment Purpose Test

- ⌘ Would for profit investors make same investment
 - Interest rate
 - Risk level
 - Level of security
 - Time to payout
- ⌘ Would investment fit within parameters of PF's investment policy
- ⌘ Key is analyzing at front end of investment (document!)

No Political Purpose Test

- ∞ Absolute prohibition on:
 - Attempting to influence legislation
 - Political campaign intervention



PRIs and the Prohibitions

☞ Minimum Distribution Requirement:

- PRIs are qualifying distributions
- Not included in asset base while outstanding
- Recaptured in year repaid

☞ Self-Dealing:

- Avoid improper “co-investments”
- Avoid indirect self-dealing as a result of “controlled organization”

☞ Excess Business Holdings:

- Not applicable to PRIs (see 53.4943-10(b))

☞ Jeopardizing Investments:

- By definition, if an investment is a PRI, it will not be a jeopardizing investment
- Take care to meet *all* PRI elements

☞ Taxable Expenditures:

- Must exercise ER where made to other than public charities

Private Operating Foundations

- ✎ Directly carry on charitable activities, instead of making grants to other organizations
- ✎ Donors receive more liberal public charity deductibility limits
- ✎ Must meet the “income test” **AND** one of three **OTHER** tests
 - “assets test”
 - “endowment test”
 - “support test”
 - Computation Period: Based upon year in question and the three preceding years

“Income Test”

- ✎ Must distribute Substantially All of the lesser of its Adjusted Net Income or its Minimum Investment Return directly for the active conduct of its exempt purpose
 - Does not include grants to other organizations
- ✎ Substantially All – means 85% or more
- ✎ Adjusted Net Income – gross income less deductions allowable to a corporation
 - Does not include gifts, grants or contributions
- ✎ Minimum Investment Return – 5% of the assets not used directly in carrying out exempt purposes (same test as Minimum Distribution for a Private Foundation)

Assets/Endowment/Support Tests

∞ Assets Test

- Substantially more than $\frac{1}{2}$ of assets must be held for use for exempt function activities
 - Defined to be 65% or more

∞ Endowment Test

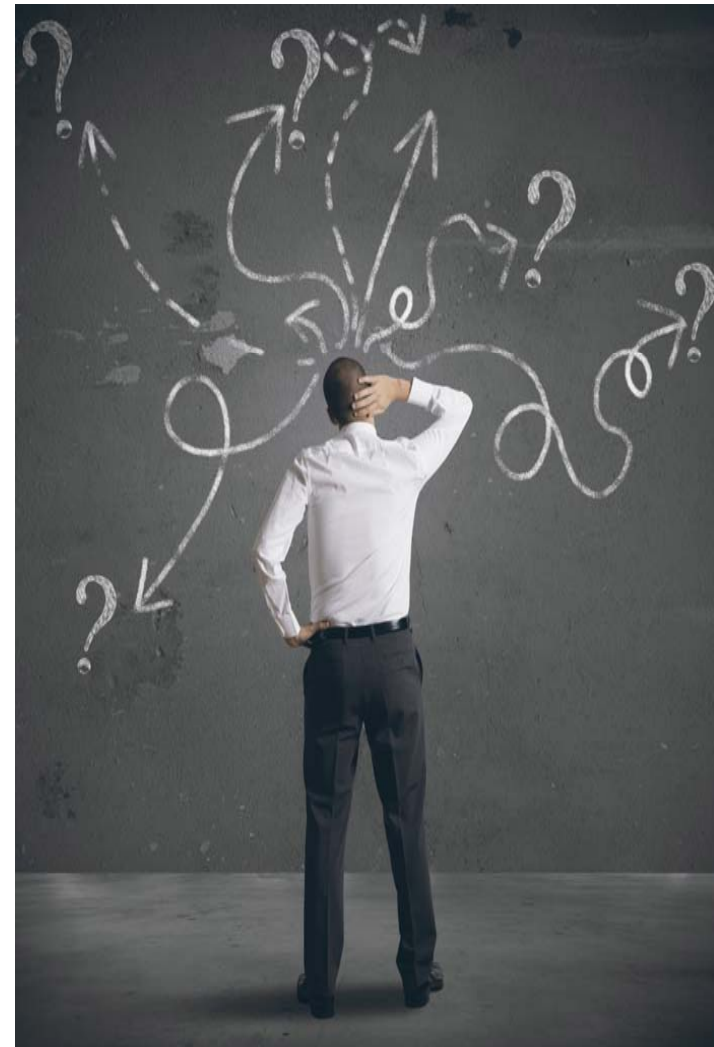
- Direct distributions of at least $\frac{2}{3}$ of the Foundation's Minimum Investment Return, or $3\frac{1}{3}\%$ of its endowment

∞ Support Test

- At least 85% of the organization's Support (excluding Gross Investment Income) must be from a combination of the general public and 5 or more exempt organizations and
 - Not more than 25% of Support (excluding Gross Investment Income) must be from any one exempt organization and
 - Not more than 50% of Support be from Gross Investment Income

Enterprise Structure

- ☞ New/Expanding Business Activity
- ☞ Liability Concerns
- ☞ Management
- ☞ Other Reasons



Considerations in Selecting the Vehicle

- ☞ Impact on Exempt Status of the Owner/Parent
- ☞ Unrelated Business Taxable Income Issues
- ☞ Control and Management
- ☞ Owner/Parent Liability
- ☞ Managing the Relationship

Impact on Exempt Status of Owner/Parent



- ∞ Flow through entities create most concern
 - Aggregate approach:
 - Rev. Rul. 98-15
- ∞ Corporate entities generally not a concern
 - Exercise caution if parent is a private foundation

UBTI Considerations

- ✎ Flow through entities: Unrelated income flows through to exempt partner
- ✎ Corporate entities: Taxed at C corp level; passive payments to EO deductible by C corp and not taxable to EO

unless

- ✎ C corp is controlled by EO:
 - 512(b)(13) alters general UBTI rule re passive income (other than dividends)

Owner Liability for Vehicle

State law applies to claims of piercing the corporate veil

- ✎ Contractual obligations: alter ego/sham to perpetrate a fraud require *actual fraud* for direct personal benefit of shareholder
- ✎ Torts: injustice or inequity will result if separate corporate existence is recognized
 - Avoid complete overlap of governing persons
 - Ensure arms-length dealings
 - Appropriately capitalize the subsidiary
 - Don't commingle funds

Maintaining the Vehicle: Controlled but Separate

- ✎ Subsidiary reasonably capitalized (parent may capitalize through equity contributions)
- ✎ Arm's-length transactions (leases, services agreements)
- ✎ Separate bank accounts and books
- ✎ Avoid 100% overlap of the boards and officers
- ✎ Officers of the sub report to sub's board who control sub
- ✎ Make clear to third parties that the organizations are separate:
 - Clarity when signing agreements; separate letterhead; business cards that show separate identities

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.

Non-lawyers are advised to consult an attorney before undertaking any issues addressed herein.