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LEGAL GUIDE:
PRIVATE FOUNDATIONS

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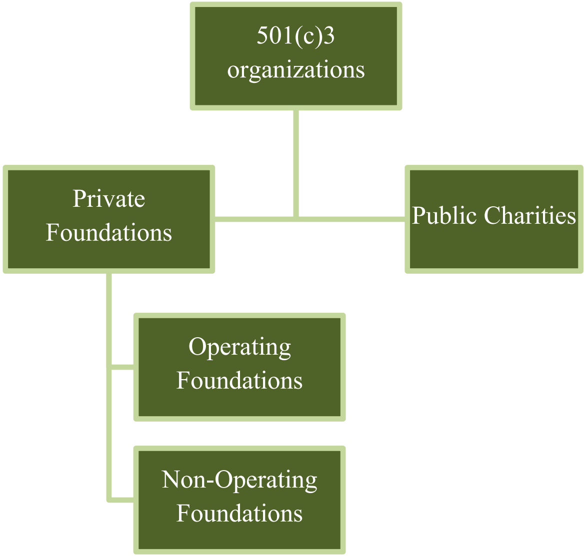
PRIVATE FOUNDATIONS are tax-exempt organizations that generally focus on philanthropic giving rather than operating their own charitable programs. Private foundations are often successful vehicles for families, businesses, and individuals to channel their resources for good. They also serve as an essential funding source for new and innovative charitable projects. However, because private foundations are seen as less accountable to the public at large than other nonprofits, they are subject to more careful scrutiny by the Internal Revenue Service. Even inadvertent missteps may result in significant penalties or the loss of exempt status.

Klamp & Associates has created this simple guide to introduce the federal tax rules governing private foundations. Please note that this guide is not intended to serve as legal advice and only addresses the general concerns of non-operating private foundations. Consult with an attorney to obtain formal legal advice on how to create and manage a private foundation.

KLAMP & ASSOCIATES, P.C. is a law firm based in Washington, DC that is dedicated to representing nonprofits and social enterprises. Our mission is to provide quality legal services to organizations of all sizes that are working to serve the public interest. We believe that the needs of our clients are best met by addressing potential legal problems before they arise. We provide effective, reliable, and innovative legal work for our clients with the goal of enhancing and expanding the services they provide. Our clients include international development NGOs, civil rights groups, environmental and religious organizations, scientific research institutions, private foundations, professional associations, and a broad range of other nonprofits and social enterprises.

WHAT IS A PRIVATE FOUNDATION?



Private foundations are one of two categories of 501(c)(3) tax-exempt nonprofit organizations, the other category being public charities. An organization is automatically classified as a private foundation unless it can show that it meets the "public charity" test. A nonprofit can qualify as a public charity if it (1) belongs to a narrow category that is traditionally seen as charitable and accountable to the public, such as churches, schools, and hospitals, (2) receives significant financial support from the general public, government, or other public charities, or (3) serves as a supporting organization for another public charity.

Most private foundations are created to fund charitable work performed by other nonprofits rather than carry on their own programs. These private foundations, called **non-operating foundations,** comprise over 95% of private foundations in the United States. The information in this guide primarily covers these types of private foundations.

In contrast, **operating foundations** devote most of their resources to the active performance of charitable activities. A well-known example of an operating foundation is the Bill and Melinda Gates Foundation. Operating foundations are exempt from some of the rules in this guide.

In practice, most private foundations are created by families and businesses to facilitate their philanthropy. Because private foundations do not generally fundraise from the public, they are sometimes seen as less accountable and more susceptible to misuse than public charities. Indeed, some private foundations have been abused as tax shelters for the wealthy. As a result, they are subject to close scrutiny by the IRS. The chart on the next page compares the regulation of private foundations to that of public charities. To ensure their compliance, foundations must file **Form 990-PF** each year with the IRS, disclosing their activities and transactions in detail. These information returns are available to the general public.

WHAT ARE THE RULES?

In order to ensure that private foundations serve charitable purposes, the IRS imposes three rules:

1. Foundations must use 5% of their assets for charitable purposes each year. These are called "qualifying distributions." Any amount above the 5% may be carried over to satisfy future qualifying distributions (for up to five years). Failure to do so may result in penalty taxes up to 130% of the undistributed amount. Qualifying distributions include grants, program-related investments, and direct programming expenses.

Disqualified Persons

- Substantial contributors (accounting for over $5,000 **and** more than 2% of total contributions in a given year)
- Managers (officers, directors, key employees)
- Persons who own or control more than 20% of an entity that is a substantial contributor
- Family members of disqualified persons (spouse, parent, grandparent, or direct descendant)
- Entities that are more than 35% owned or controlled by disqualified persons

2. Foundations must pay taxes on investment income. The rate is generally 2%, but may be lowered to 1% in years when the foundation has increased its charitable spending.

3. Foundations must pay penalty taxes on transactions that have the potential to inappropriately benefit insiders or are not charitable. Insiders affected by these rules are called "**disqualified persons**" – see the box above for what this term includes. Taxable transactions include lobbying and political expenditures, self-dealing transactions, and owning too much of a for-profit business.

Activity	Public Charity	Private Foundation
Charitable spending	No minimum requirement	Minimum annual requirement
Investment income	Not taxable if investments are passive or related to the exempt mission	Taxable
For-profit subsidiary	Permitted so long as the charity does not confer private benefits to the business	Prohibited and taxable
Lobbying	Permitted so long as it is not a substantial portion of the overall activities	Prohibited and taxable

FOUNDATION GRANTMAKING

Grantmaking is the most common way to fulfill the 5% qualifying distribution requirements.

Grants to Public Charities are the simplest option. Foundations need only to verify the recipient's public charity status.

Grants to Government entities, such as public schools and libraries, are allowed so long as the funds are for an "exclusively public purpose." Foundations often include this language as a stipulation in their grant agreements.

Grants to Individuals are permitted so long as the IRS pre-approves the foundation's grant-making process as "objective and non-discriminatory." In addition, the grant must be for (1) education at a school with a regular faculty, student body, and curriculum, (2) an award for past achievements and not contingent on future activities, or (3) a particular project or to enhance a particular skill.

All Other Grants, including grants to foreign charities and for-profit businesses, require due diligence by the foundation to ensure that the grant funds are used for charitable purposes. Foundations have two options for due diligence procedures:

- An Equivalency Determination requires the foundation to (1) collect a large volume of information on the prospective grantee and (2) have a qualified tax practitioner (such as a CPA or attorney) prepare an affidavit swearing that the grantee is the equivalent of a U.S. public charity. This option is time-consuming initially but less so over the long term.

- Expenditure Responsibility requires the foundation to (1) conduct a pre-grant inquiry, (2) sign a grant agreement requiring the grantee to use the funds charitably, report on the use of funds, and repay any misused or unused amounts, (3) obtain periodic reports on how grant funds are used, (4) inform the IRS of the grant on the foundation's tax return, and (5) take reasonable steps to recover any misused funds. This option involves ongoing due diligence over the life of the grant.

Grants for Advocacy Work

Private foundations are forbidden to lobby, but what about funding other organizations that lobby? According to the IRS, foundations may make general support grants to public charities that carry on lobbying, so long as the foundation doesn't earmark the funds for lobbying. Once the funds are granted, the grantee may opt to use some or all of them for lobbying purposes, but must comply with IRS lobbying restrictions for public charities.

OTHER QUALIFYING DISTRIBUTIONS

While most foundations fulfill their qualifying distribution requirements through grantmaking, they can also count (1) expenditures for direct charitable activities and (2) program-related investments.

Direct Charitable Activities

Foundations may carry on activities for charitable, educational, religious, literary, and scientific purposes. For example, a foundation could operate a school, establish a health clinic for the poor, or help homeless people find work. The expenditures from these activities, including staff salaries, rent, and other overhead, will generally count as qualifying distributions.

There are a couple of limitations to keep in mind. First, the foundation's governing documents (i.e. the articles of incorporation) must allow it to carry on direct charitable activities rather than restrict it to just making grants. Second, the foundation's activities must be charitable by IRS standards, meaning that they cannot be commercial or confer undue benefits to private individuals or businesses.

Program-Related Investments

Program-related investments (PRIs) are an increasingly popular but still underused option for foundations. A PRI is an investment that meets two criteria. First, it has a **primary charitable purpose**. This means that it will significantly further a charitable purpose and would not have been made *but for* that charitable impact. Second, it has **no significant purpose to make money**. To demonstrate this, the investment should be distinguishable from a commercial investment. For example, it may be extremely risky, have a very low interest rate, and/or have generous payment or collateral requirements. Please note that interest from PRIs is taxable as investment income. The following are examples of investments the IRS has formally designated as meeting the PRI criteria:

- Low-interest or zero-interest loans to needy students.
- High-risk investments in nonprofit, low-income housing.
- Low-interest loans to small businesses owned by members of economically disadvantaged groups who cannot access commercial financing on reasonable terms.
- Investments in businesses in deteriorated urban areas to improve the economy and provide employment opportunities.
- Investments in nonprofit organizations combating neighborhood deterioration.

WHAT ARE THE LEGAL LANDMINES?

Foundations and their leaders may be severely penalized for transactions that are not charitable and/or have the potential to benefit a disqualified person. Even accidental violations of the rules may result in high penalties and lead to personal liability for the individuals who approved or benefited from the transaction.

When a foundation discovers that it has violated a regulation, the best course is to **correct the violation as soon as possible**. The initial penalties will continue to accrue each year until the violation is corrected. Furthermore, the IRS can impose large additional penalties if a violation is not corrected in a timely manner.

Self-Dealing

The IRS prohibits almost all transactions between the foundation and disqualified persons. For example, a foundation that pays rent, makes a loan, or sells goods to a disqualified person may be subject to self-dealing penalties. There are a few narrow exceptions to this rule. The most important is that a foundation is allowed to pay reasonable compensation to a disqualified person for legal, accounting, and similar services that are necessary to carry on the foundation's charitable purposes. A disqualified person is also allowed to donate property to a foundation so long as the property is not subject to a lien.

Case in Point

A foundation is in need of affordable office space. The president, who owns a small company, offers the foundation an unused space in the company's building. She offers the foundation a 50% discount from the usual rental price, making it much cheaper than the foundation's other options. Even though this would benefit the foundation, it would still be a taxable self-dealing transaction.

Case in Point

A foundation hosts an annual fundraising dinner for its supporters, who contribute $100 for a ticket. In order to avoid empty tables, the foundation directors are invited to bring their spouses at no charge. The spouses are disqualified persons and receive a free dinner from the foundation, so this constitutes an act of self-dealing. Please note that the directors *themselves* may have the cost of their tickets reimbursed if they are performing official duties at the dinner, such as making a presentation to the attendees.

Excess Business Holdings

A foundation has "excess business holdings" if the foundation and all of its disqualified persons collectively own a certain amount of voting stock in a business (generally, more than 20%).

There are exceptions if (1) the business is substantially related to the foundation's mission, (2) the foundation itself owns no more than 2% of the business, or (3) the business's income is at least 95% passive (i.e. from interest or royalties).

Taxable Expenditures

Certain foundation expenditures are always taxable. Taxable expenditures include any amount that a foundation spends on lobbying or political activity, including operating a nonpartisan voter registration drive (which public charities are permitted to do tax-free). In addition, if a foundation makes a grant to an individual for travel, study, or research without following the procedures detailed above, the grant is considered a taxable expenditure. Similarly, if a foundation makes a grant to an organization without public charity status and does not obtain an equivalency determination or follow the expenditure responsibility rules, the grant is a taxable expenditure. Grants for purposes that are not charitable are likewise taxable.

Jeopardizing Investments

A jeopardizing investment is basically a risky investment – one that shows a lack of "ordinary business care and prudence" and jeopardizes the foundation's charitable assets. The IRS determines whether an investment is too risky by holistically reviewing the foundation's entire investment portfolio, so there is not a particular type of investment that will automatically be considered jeopardizing. It is important to regularly review the investment portfolio, as an investment that initially seems prudent may become less so over time. As discussed above, there is also an exception for program-related investments, which are often designed to take risks that conventional lenders would not take.

Please note that in addition to the IRS rules, state laws also require prudent management of institutional funds. Risky investments could therefore result in penalties against a foundation at the state level as well.

Case in Point

A foundation makes a grant to a girls' school in Senegal for the purchase of musical instruments. The foundation follows all of the IRS expenditure responsibility rules in approving the grant. Two years later, the foundation hires a new grants manager. The new employee doesn't realize that the IRS still requires the foundation to collect reports on how the musical instruments are being used. The staffer neglects to ask the school for reports, and the school does not provide them. Because the foundation is no longer exercising expenditure responsibility, the grant could become a taxable expenditure.

SUMMARY

While private foundations are closely regulated, it is not overly complicated to follow the IRS rules and ensure that the foundation resources are used for good. By following best practices and consulting with counsel, foundations can effectively pursue their mission without jeopardizing their tax-exempt status or incurring penalties. Below is a simple chart showing the risk associated with different foundation activities.

GREEN LIGHT *Allowed with basic due diligence*

- Grants to public charities.
- Grants to government entities for exclusively public purposes.
- Direct charitable activities.

YELLOW LIGHT *Allowed with more intensive due diligence*

- Grants to organizations that do not have public charity status.
- Grants to individuals.
- Program related investments.

RED LIGHT *Generally forbidden - consult a professional before relying on any exceptions*

- Transactions with disqualified persons.
- For-profit subsidiaries.
- Lobbying, political activity, and voter registration.

For Further Information:

IRS Private Foundation Page: http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Private-Foundations
Foundation Source: https://www.foundationsource.com
Council on Foundations: www.cof.org
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