Avoiding Common Private Foundation Mistakes
Agenda

• Why this Presentation?
• Basic Definitions/Foundation Excise Taxes
• Self-Dealing Mistakes
• Proper Procedures for Grants to Foreign Organizations
• 990-PF Common Errors
• Planning Tips
• Recordkeeping and Processes
• Tax rules applicable to private foundations are complicated and not always intuitive

• Most foundations run into problems with “self-dealing” rules, which prohibit almost all financial transactions between a foundation and its “disqualified persons”

• Foundations also encounter problems when making grants to other organizations, particularly grants to foreign organizations

• New rules issued 9/2015 regarding certain types of grants to foreign organizations
Why this Presentation?

- Foundation returns are complicated and often not prepared correctly
- The Form does not flow in any type of logical progression
- IRS estimates 60 hours to learn applicable laws to prepare the form—so, it’s even hard to prepare for many practitioners
- Returns are open to public inspection—Foundation Center and Guidestar
- Reliance on CPA or other preparer to get it right
Where Private foundations Fit in the 501(c)(3) Universe

501(c)(3)

Public Charities

509(a)(1)  509(a)(2)

509(a)(3) Supporting Organizations

Type I  Type II  Type III

FI  NFI

Private Foundations

Operating  Grant-making
• Self-dealing transactions (a variety of transactions with disqualified persons)
  – Sales, exchanges, leases
  – Furnishing of goods, services, facilities
  – Payment of compensation or reimbursement of expenses
  – Exceptions

• Mandatory Payout
  – In general, a foundation must pay out 5% of its noncharitable assets

• Excess Business Holding Rules
  – Designed to prevent the control of a for-profit business by the private foundation; generally, more than 20% interest
Jeopardizing Investment Rules
- Penalties are imposed if foundation makes investments that jeopardize the ability of the foundation to carry out its exempt purpose
- Foundation managers failed to carry out ordinary business care
- No investments are automatic violations
- Important exception: PRIs

Taxable Expenditure Rules
- Impermissible expenditures:
  - Lobbying
  - Influencing public elections
  - Grants to individuals without IRS approval
  - Grants to organizations that aren’t public charities (expenditure responsibility required)
  - Expenditures for non-charitable purpose
  - Grants to Type III non-functionally integrated supporting organizations
# Chart of Taxes

<table>
<thead>
<tr>
<th>IRC Section</th>
<th>Sanction</th>
<th>Tax Imposed On</th>
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<tbody>
<tr>
<td>4940</td>
<td>Investment income tax</td>
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<tr>
<td></td>
<td></td>
<td>Private Foundation Managers Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1% - 2%</td>
</tr>
<tr>
<td>4941</td>
<td>Self-dealing Self-dealer</td>
<td>X</td>
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<tr>
<td></td>
<td></td>
<td>Self-dealer Foundation manager Tax</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10%-200%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5%-50%</td>
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<tr>
<td>4942</td>
<td>Undistributed income</td>
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<tr>
<td></td>
<td></td>
<td>30% -100%</td>
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<tr>
<td>4943</td>
<td>Excess business holdings</td>
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<tr>
<td></td>
<td></td>
<td>10% - 200%</td>
</tr>
<tr>
<td>4944</td>
<td>Jeopardizing investments</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>10%-25%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>4945</td>
<td>Taxable expenditures</td>
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<tr>
<td></td>
<td></td>
<td>20% - 100%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5%-50%</td>
</tr>
</tbody>
</table>
Basic Rule: No transactions with “disqualified persons”

- Officers, directors, trustees
- Substantial contributors
- Person who owns more than 20% of a corporation, partnership, trust, or unincorporated enterprise that is itself a substantial contributor
- Family member of an individual described above
- Corporation, partnership, trust, or estate in which persons described above own more than 35%
Self-Dealing Mistakes

Penalty Excise Tax

• **On Disqualified Person:**
  – Initial tax of 10% of the “amount involved”
  – Second-tier tax of 200% if not corrected
  – Due even if self-dealer unaware
  – Due even if transaction is fair to foundation

• **On Foundation Managers:**
  – Initial tax of 5% of the amount involved (up to $20,000 per act)
  – Second-tier tax of 50% if not corrected
  – Applies to managers who approved the transaction knowing it was self-dealing

• No abatement
Can our foundation compensate a family member for services?

- Basic rule: Yes, so long as compensation is reasonable and for personal services necessary to carry out the foundation’s charitable functions
  - Personal Services: Foundation management, legal, accounting, investment
    - Property management? Non-professional services?
  - How do you determine reasonable compensation?
Can our foundation pay travel expenses for disqualified persons?

- Most foundations don’t compensate family members who sit on boards, but no prohibition if fees are reasonable.
- Foundation assets generally cannot be used to finance the travel or other expenses of family members (e.g., spouses and children) who have no role in the foundation.
Who can use tickets or tables our foundation receives for grants made in support of fundraising events, charity benefits, museums, performing arts organizations?

- Foundation officers, directors, and managers (even if employees of foundation’s corporate founder) if reasonable and necessary to performance of oversight, evaluation and monitoring tasks for Foundation.
- Spouse of foundation employee?
- Disqualified persons (including, company officials) who have no role in foundation may not use tickets
- Bifurcation not permitted
Can our foundation share office space, equipment and/or employees with a disqualified person?

• Potential acts of self-dealing:
  – Sale, exchange, or lease of property
  – Furnishing of goods, services, or facilities
  – Payment, compensation, or reimbursement of a disqualified person

• Exceptions:
  – Permissible if resources provided to foundation for no charge
  • “fair” or “below market” terms are not a defense
  – Permissible if foundation and DP enter into separate lease agreements
    or equipment contracts with non-disqualified person
  – Permissible for foundation to reimburse DP for personal services that
    are reasonable and necessary to the foundation; employee time must
    be tracked and allocated
Can our Foundation and a disqualified person invest in the same investment partnership?

- IRS guidance on issue isn’t clear, but foundation’s purchase and redemption of shares in partnership could be viewed as a sale or exchange of property with a disqualified person (act of self-dealing)
- In a few rulings, IRS has held that purchase by foundation of a LP interest in a fund in which disqualified persons have an interest is not an act of self-dealing. But, IRS has clearly acknowledged the potential for self-dealing under such circumstances
  - PLR 200318069: Foundation’s acquisition of LP interest in an entity controlled by DPs constitutes a “co-investment arrangement,” not a sale or exchange between the private foundation and the disqualified persons
  - PLR 9726006: Foundation’s investment in LP controlled by disqualified persons could be deemed an act of self-dealing, but was not in this instance because disqualified persons would receive no “more than an incidental or tenuous benefit” where foundation’s investment would constitute only 1%-3% of the partnership’s total capital
- IRS Priority Guidance Plan
Can our foundation pay a pledge made by our founder?

• Foundation should not satisfy a pledge made by a disqualified person
  – Satisfaction of a disqualified person’s obligation is an act of self-dealing

• Does it matter if the pledge isn’t legally enforceable under state law?
  – IRS has ruled that payment of DP’s obligation by foundation is self-dealing whether or not legally enforceable

• IRS has ruled that payment of DP’s pledge may also be a taxable expenditure (TAM8534001)
Can a disqualified person use a foundation credit card for personal expenses and reimburse the foundation within a month?

• Use by a disqualified person of a foundation credit card for personal expenses is considered a loan by the foundation to the DP

• Violation of the self-dealing prohibition even if the DP repays the foundation promptly
Proper Procedures for Grants to Foreign Organizations

For grants to foreign organizations not recognized by the IRS, Foundation can use:

- Expenditure responsibility
- Equivalency determination

• Foundation can opt to conduct a foreign equivalency determination – only needs to exercise expenditure responsibility if it determines that the grantee is not the equivalent of a sec. 501(c)(3) public charity

• Foundation must make “good faith determination” and “reasonable judgment” that foreign entity meets criteria to be a 501(c)(3) public charity, based either on affidavit from grantee or opinion of counsel
• **Comparison of Alternatives:**
  - Often easier for grantors to exercise expenditure responsibility than conduct equivalency determinations
  - Equivalency determination may be preferable in certain cases:
    - Clear equivalent – e.g., grant to foreign university
    - Grants for endowments – perpetual reporting?
    - Grants for capital equipment – also potential reporting problem
    - Grants for general support
    - Grants where practical considerations make expenditure responsibility difficult – e.g., if likely to be difficult to get reports from grantee (of course, may be difficult to do equivalency determination too)
  - New regulations issued 9/2015
    - Grantee affidavit alone no longer adequate basis for “good faith determination” of equivalency
    - Foundation generally must also rely on written advice from “qualified practitioner”
    - Includes CPAs, NGOsource, in-house counsel (maybe)
990-PF Common Errors

Reporting Issues

• What does the 990-PF do?
  – Revenues and disbursements, assets and liabilities classified into meaningful categories
  – Form has special parts that fish for compliance failures
990-PF Common Errors
Reporting Issues

• Complete ALL lines of the return—“yes”, “no”, “N/A”
• Use zeros or enter “none” or N/A if a part does not apply
• Failing to allocate legitimate administrative expenses to charitable activities/purpose
• Column d must be on a cash basis even if the foundation maintains its books on an accrual basis
990-PF Common Errors

Reporting Issues

• Failing to file 990 PF with the state Attorney General in which the foundation's principal office is located; and the state in which the foundation was incorporated or created

• Not using investment related expenses to off-set net investment income.

• Failing to include Schedule B—it is open to public inspection
• Missing out on utilizing excess grant carryovers

Example a Foundation over distributes $50,000 in 2015. The foundation can use this excess to reduce its grant-making up to that amount through 2020. After 2020, the ability to use this excess is lost

• Missing out on the amount that must be distributed in the following year

• Failing to add grant recoveries to distributable amount, Part XI, line 4
990-PF Common Errors
Investment Related Issues

- Incorrect calculation on sale of stock donated to the foundation—failing to track the donor’s basis
- Failing to list all securities held—this could be pages
- Government and municipal obligations can be shown in aggregate but not grouped together
- Capital gains and losses can be net together, but cannot be less than zero
- Attaching a list of all publicly trade stock, mutual funds, bonds—can be reported as a lump sum. All other sales must be listed separately.
- Valuation of property – appraise every 5 years
Accrual, cash or modified cash

Always N/A for grant-making foundations

Must be cash basis

Other reasonable and necessary can be allocated to col b & d
<p>| Tax on net investment income | Potential taxable expenditure for political activities | By-law changes | File with state AG | Substantial contributor disclosure |</p>
<table>
<thead>
<tr>
<th>Part VII-A</th>
<th>Statements Regarding Activities (continued)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>At any time during the year, did the foundation, directly or indirectly, own a controlled entity within the meaning of section 512(b)(13)? If “Yes,” attach schedule (see instructions)</td>
</tr>
<tr>
<td>12</td>
<td>Did the foundation make a distribution to a donor advised fund over which the foundation or a disqualified person had advisory privileges? If “Yes,” attach statement (see instructions)</td>
</tr>
<tr>
<td>13</td>
<td>Did the foundation comply with the public inspection requirements for its annual returns and exemption application?</td>
</tr>
<tr>
<td>14</td>
<td>Website address: <a href="http://WWW.NOMORESNOW.ORG">WWW.NOMORESNOW.ORG</a></td>
</tr>
<tr>
<td>15</td>
<td>The books are in care of: <a href="http://WWW.JIMMYBUFFETT.COM">JIMMY BUFFETT</a>, Telephone no: <a href="http://978-594-0000">978-594-0000</a>, Located at: 123 PALM TREE DRIVE, SALEM, MA, ZIP+4: <a href="http://01970">01970</a></td>
</tr>
<tr>
<td>16</td>
<td>At any time during calendar year 2014, did the foundation have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See the instructions for exceptions and filing requirements for FinCEN Form 114, (formerly TD F 90-22.1). If “Yes,” enter the name of the foreign country:</td>
</tr>
</tbody>
</table>

Make sure this is really “no”: FBAR may be needed

Foundation ownership of a controlled entity

Transfers to a donor advised fund

Public inspection requirements
## Part VII-B Statements Regarding Activities for Which Form 4720 May Be Required

File Form 4720 if any item is checked in the "Yes" column, unless an exception applies.

1a. During the year did the foundation (either directly or indirectly):
   - Engage in the sale or exchange, or leasing of property with a disqualified person? Yes No
   - Borrow money from, lend money to, or otherwise extend credit to (or accept it from) a disqualified person? Yes No
   - Furnish goods, services, or facilities to (or accept them from) a disqualified person? Yes No
   - Pay compensation to, or pay or reimburse the expenses of, a disqualified person? Yes No
   - Transfer any income or assets to a disqualified person (or make any of either available for the benefit or use of a disqualified person)? Yes No
   - Agree to pay money or property to a government official? (Exception: Check "No" if the foundation agreed to make a grant to or to employ the official for a period after termination of government service, if terminating within 90 days.) Yes No

b. If any answer is "Yes" to 1(a)-(g), did any of the acts fail to qualify under the exceptions described in Regulations section 53.4941(d)-3 or in a current notice regarding disaster assistance (see instructions)? ... Yes No

c. Organizations relying on a current notice regarding disaster assistance check here...

d. Did the foundation engage in a prior year in any of the acts described in 1(a), other than excepted acts, that were not corrected before the first day of the tax year beginning in 2014? Yes No

2. Taxes on failure to distribute income (section 4942) (does not apply for years the foundation was a private operating foundation defined in section 4942(j)(3) or 4942(j)(5))
   a. At the end of tax year 2014, did the foundation have any undistributed income (lines 6d and 6e, Part XIII) for tax year(s) beginning before 2014? Yes No
   b. Are there any years listed in 2a for which the foundation is not applying the provisions of section 4942(a)(2) (relating to incorrect valuation of assets to the year’s undistributed income? (If applying section 4942(a)(2) to all years listed, answer "No" and attach statement — see instructions.) N/A
   c. If the provisions of section 4942(a)(2) are being applied to any of the years listed in 2a, list the years here.

3a. Did the foundation hold more than a 2% direct or indirect interest in any business enterprise at any time during the year? Yes No
   b. If "Yes," did it have excess business holdings in 2014 as a result of (1) any purchase by the foundation or disqualified persons after May 29, 1996; (2) the lapse of the 5-year period (or longer period approved by the Commissioner under section 4943(c)(7)) to dispose of holdings acquired by gift or bequest; or (3) the lapse of the 10-, 15-, or 20-year first phase holding period? (Use Schedule C, Form 4720, to determine if the foundation had excess business holdings in 2014.) N/A

4a. Did the foundation invest during the year any amount in a manner that would jeopardize its charitable purpose? Yes No
   b. Did the foundation make any investment in a prior year (but after December 31, 1969) that could jeopardize its charitable purpose that had not been removed from jeopardy before the first day of the tax year beginning in 2014? Yes No
Often incorrectly marked “No”- here the foundation made grants to 501(c)(4)s
• Distributable Amount v. Qualifying Distributions (what’s the difference)

**Distributable amount (DA)** for a grant-making foundation = mandatory payout requirement. The DA for operating, conduit, and common fund foundations is different. Line 1 (d)

**Qualifying distributions** = page 1, line 28, BUT also program related investments, set asides, assets used in carrying out charitable purposes. Line 4

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![Image of Form 990-PF page 5](image-url)
Take advantage of the 1% tax when the difference between the 1% and 2% tax rate would require a distribution. For example:

- Tax on net investment income at 2% = $40,000; tax on 1% is $20,000
- If paying an extra $20,000 in distributions the 1% tax could be obtained

Tips:

- Don’t let it drive your grant-making; but you may want to accelerate your grant-making
- The tax is based on a 5 year average of distribution giving, so a foundation needs to distribute more and more of its assets to qualify. During periods of slow asset growth it may be better to pay the 2% tax than try to distribute more to qualify for the 1% rate
- Work with your accountant or tax preparer about 1 month before the end of the year to project the 1% v. 2% tax
- Work with investment adviser in a year when you’ll be at the 2% rate
- Be aware of the undistributed number (Must distribute this year)
Planning Tips

Miscellaneous

• A word about alternative investments. Determine whether the investment will generate unrelated business income tax. We often see funds that trade on margin generating UBIT.

• Since capital losses can’t be carried forward or backward, consider strategically selling appreciated assets in the same year you have losses.

• Consider donating highly appreciated securities with low cost basis.

• Investments in limited partnerships and foreign hedge funds should be reviewed to make sure no foreign tax filings are required.

• Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation) and Form 8865 (Return of U.S. Persons with Respect to Certain Foreign Partnerships).

• Make sure FBAR(s) (Foreign Bank Account Report) are filed.

• If officers or managers are paid, have an independent consultant review their compensation plan.
Recordkeeping and Processes

- Develop a systematic way of recording and capturing a foundation’s monetary transactions
- Maintain a database that tracks grants made and evaluating the success of grant-making policy
- Keep track of grant requests received, awarded, rejected
- Maintain a database of follow up actions taken with grantees, including due dates for multiyear grants
- Develop a system of internal controls to protect foundation assets, including check signing controls
- Conflict of interest
- Develop a compliance calendar, including filing (extension dates), excise tax payment dates, taxes due on real or intangible personal property
- Follow up reports for expenditure responsibility grants
- Board responsibilities - meet at least annually
- Develop an investment policy