Private Foundations 101: A Refresher for Board Members and Management

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The information presented here should not be construed as legal, tax, accounting or valuation advice. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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Private Foundation Tax Webinar Series

Webinar #1
Leveraging Private Foundations During Challenging Times

Webinar #2
Private Foundations 101: A Refresher for Board Members and Management

Webinar #3
Private Foundation Compensation and Other HR Issues

Webinar #4
Investment Related Issues for Private Foundations

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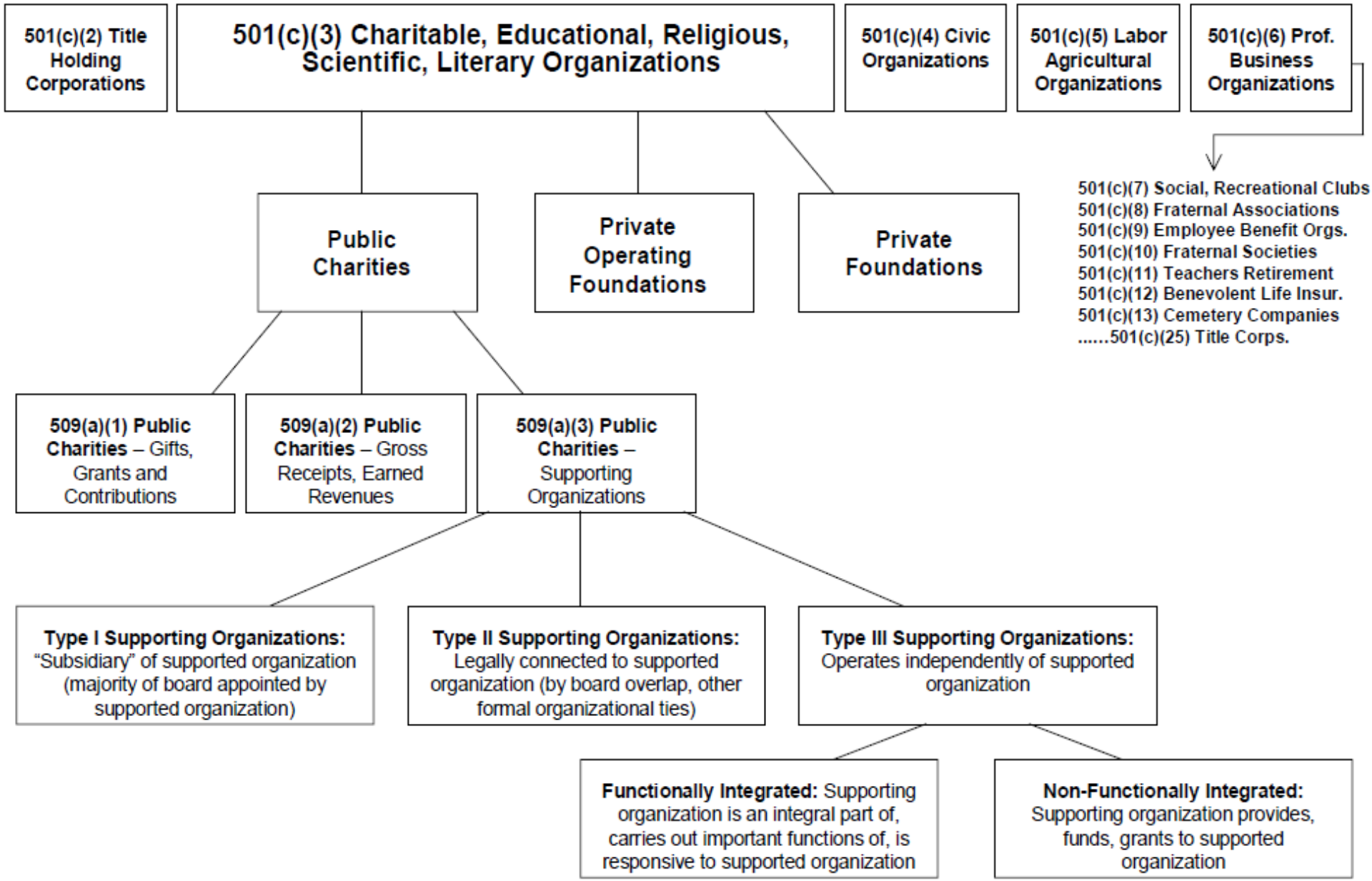
Tax-Exempt Organization Reference Chart

Internal Revenue Code Section:



Types of Private Foundations

- Private Endowed Foundation
  - Most common type of private foundation
  - Creates a principal- or endowment- for investment and pay out income from the endowment annually to charity
- Pass-Through Foundation
  - Distributes all of the contributions that it receives each year
  - May make or revoke the pass-through option on a year-to-year basis
- Private Operating Foundation
  - Uses the majority of its income to actively run its own charitable programs or services

Private Foundations 101: A Refresher for Board Members and Management

https://www.marcumllp.com/press-releases/20-questions-for-private-foundations

Twenty questions your Board should know the answer to:

1. Do you maintain a current list of disqualified persons?
2. Has the foundation engaged in any self-dealing transactions with a disqualified person?
3. Has the foundation received tickets or other quid pro quo items that were used by disqualified persons?
4. Does the foundation control another organization?
5. Does the foundation have net capital losses or plan on selling investments at a loss?
6. Does the foundation historically pay the 2% tax on net investment income rather than a reduced 1% tax?
7. Does the foundation receive donated highly appreciated stock that it is planning on selling?
8. Is the foundation meeting its annual minimum distribution requirements?

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Disqualified Persons

Disqualified persons are individuals or organizations a private foundation is deemed to be related to and with which the private foundation is limited from engaging in transactions which may create self-dealing or excess business holding issues (discussed below). Disqualified persons include the following:

- Officers, directors or trustees of the foundation
- A substantial contributor to the foundation
- Companies or partnership substantially owned by disqualified persons
- Spouse and families of any of the above (family in this instance includes ancestors, children, grandchildren, great-grandchildren and their spouses, but not siblings)

Self-dealing

A disqualified person is restricted in the types of transactions that can be engage in with a private foundation. These transactions include:

- A sale, exchange, or leasing of property
- Lending of money or other extension of credit
- Furnishing of goods, services, or facilities
- Payment of compensation
- Transfer to or use of the income or assets of a private foundation

Question #1 – Do you maintain a list of disqualified persons?

- Disqualified persons are individuals or organizations a private foundation is deemed to be related to and with which the private foundation is limited from engaging in certain transactions.

- Disqualified persons include the following:
  - Officers, directors or trustees of the foundation
  - Employee of the foundation or other individual having powers or responsibilities similar to officers, directors or trustees
  - A substantial contributor to the foundation or owner of more than 20% of an organization that is a substantial contributor (persistent status)
  - Companies or partnerships more than 35% owned by disqualified persons (voting power or profits interest)
  - Spouse and families of any of the above (family in this instance includes ancestors, children, grandchildren, great-grandchildren and their spouses, but not siblings)

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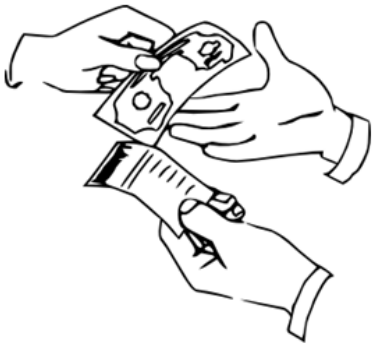
Question #2 – Have you engaged in an act of self-dealing?

- A disqualified person is restricted in the types of transactions that can be engage in with a private foundation.

- These transactions include:
  - A sale, exchange, or leasing of property
  - Lending of money or other extension of credit
  - Furnishing of goods, services, or facilities
  - Payment of compensation
  - Transfer to or use of the income or assets of a private foundation
  - Payments to government officials



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What is Self-Dealing?

- Direct or indirect self-dealing exists whether the transaction benefits or injures the foundation.
- Exceptions:
  - Payment of reasonable compensation for the performance of personal services (includes brokering, legal, investment, and banking services)
  - Provision of facilities by a disqualified person to a related private foundation without charge
  - Loans or extension of credit by a disqualified person to a related private foundation without charge
  - Benefits received by the disqualified parties are no more than those that would be received by the general public

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Reasonable Compensation

What is reasonable compensation? The IRS defines reasonable compensation as "the value that would ordinarily be paid for like services by like enterprises under like circumstances."

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Consequences of Self-Dealing

- First tier tax of 10% (5% for managers)
  - Self-assessed and nonwaivable
  - Undoing the transaction to the extent possible
  - Beware the correction does not create another self-dealing transaction
  - Assessed on the self-dealer
  - Participating managers may also be assessed if willful and not due to reasonable cause (5%)
- Second tier tax of 200% (50% for managers)
- Termination tax if self-dealing is not cured

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Question #3 – Have donee tickets been used by disqualified persons?

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Personal Family Pledges

A legally binding pledge is a personal debt, and if a disqualified person makes such a pledge, it is an act of self-dealing for a foundation to pay that debt.

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Question # 4 – Does the foundation control another organization?

Acts with controlled organizations are generally treated as though the act was performed by the private foundation itself. An organization is treated as controlled by a private foundation if the foundation, one or more foundation managers, or disqualified persons of the foundation can, by aggregating their votes or authority, require the organization to engage in the self-dealing transaction.

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Question #5 – Does the foundation have net capital losses?

- Net capital gains are part of net investment income used to calculate a foundation's excise tax.
- Capital losses from the sale (or other disposition) of investment property can reduce capital gains recognized during the tax year, but it can't go below zero.
- If foundation has net capital losses at year end, the excess losses may not offset gross investment income.
- Net capital losses cannot be carried back or carried forward to offset gains in prior or future tax years.
- "Use it or Lose it!"

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Question #6 – Does the foundation qualify for the reduced tax rate?

- Based on percentage of grants paid compared to prior 5 year average
- 2% Tax vs. 1% Tax
- New rate of 1.39% effective for tax year beginning after December 20, 2019
- Estimate tax payments

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Question #7 – Does the foundation have highly appreciated stock?

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Question #8 – Is the foundation making its minimum distributions?

Generally, a foundation is required to distribute an amount equal to approximately 5% of the fair market value of its assets every year.

Foundations have a one-year grace period to make the required distribution.

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Minimum Distribution Requirements

- Qualifying distributions include:
  - Actual disbursements paid to accomplish an exempt purpose
  - Reasonable and necessary administrative expenses

- Question #9 – Has the foundation considered setting aside funds in order to meet the minimum distribution requirements?

- Question # 10 – Does the foundation have any charitable use assets or program-related investments that it can exclude from its minimum distribution calculation?

Question #11 – Does the foundation invest in risky investments?

- An investment is a jeopardizing investment if it is determined that the foundation managers/directors when making the investment in providing for the long and short term financial needs of the foundation, failed to exercise ordinary business care and prudence.
- Foundation should implement an overall investment strategy with certain risk and return objectives appropriate for furthering its exempt purpose
- IRS lists the following investments that are closely scrutinized:
  - Trading securities on margin
  - Trading commodity futures
  - Investment in working interest in oil and gas wells
  - Purchase of puts, calls, and straddles
  - Purchasing warrants, and
  - Selling short
  - Investment in “junk” bonds
  - Risk arbitrage
  - Hedge Funds
  - Derivatives
  - Distressed real estate
  - International equities in third world countries

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Question #11 – Does the foundation invest in risky investments?

- Excise tax penalties:
  - 1st tier tax-
    - Penalty imposed on foundation- 10% of the amount invested.
    - Penalty imposed on foundation manager- 10% of the amount invested.
  - 2nd tier tax-
    - An additional 25% tax is imposed on foundation if not corrected.
    - An additional 10% tax is imposed on the foundation manager

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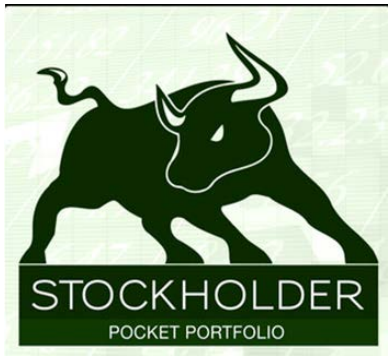
Question #12 – Does the foundation have any excess business holdings?

- IRS prohibits a private foundation, together with its disqualified persons, from holding more than 20% interest in a given business enterprise. The 20% must be reduced for each percentage of voting stock owned by disqualified persons.
  - Therefore, if a disqualified persons own more than 20% of the voting stock, the foundation cannot own any nonvoting or voting stock in the entity.
- If disqualified persons own 20% or less of voting stock of a corporation, a foundation's ownership of nonvoting stock is treated as a permitted holding
- If the foundation could demonstrate that a third party person, who is not a disqualified person, effectively controls the business, this limit could increase to 35%.
- A private foundation is not treated as having excess business holdings in any corporation in which it owns 2% or less of the voting stock and 2% or less of the value of all shares outstanding.
- Five (5) year grace period for business holdings that are obtained through gift or bequest.



Does the foundation have taxable expenditures?

Question #13 – Does the foundation provide grants to non-public charities or taxable entities?

Question #14 – Does the foundation provide scholarships or other type of grants directly to individuals for travel, study, or similar purposes?

Question #15 – Does the foundation provide grants or wish to provide funding to foreign charities?

Question #16 – Does the foundation engage in political or lobbying activities or have any expenditure related to such activities?

Taxable Expenditures

Excise tax penalties:

- 1st tier tax-
  - Penalty imposed on foundation- 20% of the amount expended,
  - Penalty imposed on foundation manager- 5% of the amount expended, up to a maximum tax of $10,000 for any expenditure.

- 2nd tier tax-
  - An additional 100% tax is imposed on foundation if not corrected,
  - An additional 50% tax is imposed on the foundation manager up to a maximum tax of $20,000 for any expenditure.

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Expenditure Responsibility

- **Exception to Taxable Expenditures-**
  - Exercising expenditure responsibility:
    - Pre grant inquiry-
      - Conducted by the foundation before making such grant.
      - Provides basic information about the grantee organization and enables the foundation to have the reasonable assurance that the grantee is capable of fulfilling the charitable purposes of a grant.
    - Written grant agreement-
      - Commitment signed by an officer of the grantee organization that includes spending and reporting responsibilities.
      - Commitment signed stating that the grant funds are only used for an intended purpose

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Expenditure Responsibility

- **Exercising expenditure responsibility- cont'd:**
  - Reports from grantees-
    - File reports on the use of grant funds showing compliance with the terms of the grant.
    - Mandatory progress reports toward achieving the intended purpose.
    - Grantees not organized as IRC Section § 501(c)(3) are required to maintain grant funds in a separate account designated for the charitable purpose.
  - Report to IRS due with Form 990-PF (for each grant)-
    - Name and address of the grantee
    - Date, amount and purpose of the grant
    - Amounts expended by the grantee
    - Whether the grantee has diverted any portion of the funds from the intended purpose.
    - Dates of any reports received from the grantee
    - Dates and results of any verification of those reports.

Do the foundation have unrelated business income?

Question #17 – Does the foundation engage in any activities unrelated to its exempt purpose?

Question #18 – Does the foundation use debt to finance the purchase of any income producing assets (including the use of margin accounts)?

Question #19 – Does the foundation invest in partnerships?

Question # 20 – Has the foundation satisfied all of its disclosure requirements?

- *Substantiation requirements* – must acknowledge donations greater than $250
- *Quid pro quo reporting requirements* – must acknowledge donations greater than $75 when goods or services are given to the donor in return
- *Annual reporting requirements* – required to file federal Form 990-PF and possibly additional state filings
- *Public disclosure rules* – must make the annual report and exemption application available for public inspection

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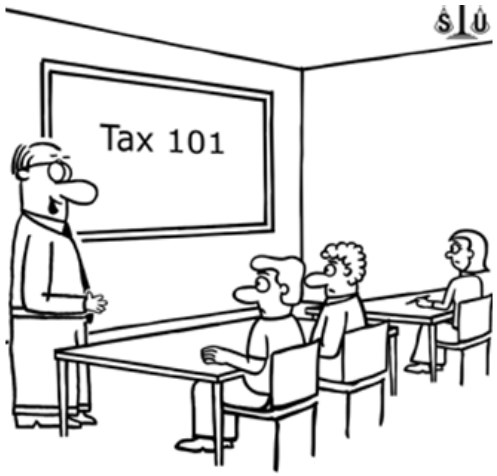
Internal Revenue Code



The Internal Revenue Code is absurdly complex or, as we lawyers say, a goldmine.

- IRC §4940 – Excise Tax Based on Investment Income
- IRC §4941 – Taxes on Self-Dealing
- IRC §4942 – Taxes on Failure to Distribute Income
- IRC §4943 – Taxes on Excess Business Holdings
- IRC §4944 – Taxes on Investments Which Jeopardize Charitable Purpose
- IRC §4945 – Taxes on Taxable Expenditures

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Resources

- Form 990-PF Instructions
- Publication 578
- www.IRS.gov
- 20 Questions
- PPC Deskbook
- BNA Portfolios

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Questions

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