

PRIVATE FOUNDATIONS

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I. Foundation Classifications

There are two basic types of foundations: private foundations and operating foundations.

A. Private Foundations

Private foundations are not expressly defined by the federal statute. The statute, instead, states that any charitable organization that does not qualify as a public charity is a private foundation. See I.R.C. § 509(a) (1999). A public charity is an institution that has broad public support or an institution that functions in a supporting relationship to one or more public supported entities. See I.R.C. § 508(b) (1999). Thus, the typical characteristics of a private foundation are that it is funded from one source, its ongoing funding is in the form of investment income, and it makes grants for charitable purposes to other persons. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 11.1 (7th ed. 1998).

B. Operating Foundations

There are two types of operating foundations: a private operating foundation and an exempt operating foundation.

1. Private Operating Foundations (non-exempt)

The defining characteristic of a private operating foundation is that it operates its own programs, unlike a private foundation in which the foundation makes grants to other organizations. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 11.1(b) (7th ed. 1998). Private operating foundations are exempt from making mandatory distributions, but they must pay a 2 percent excise tax.

To qualify as a private operating foundation, the foundation must meet an income test and either an asset, endowment, or support test. See I.R.C. § 4942(j)(3)(A) (1999); Tres. Reg. § 53.4942(b)-1(a) (1999); I.R.C. § 4942(j)(3)(B)(i-iii) (1999). The tests may be met during either 1) any three years during a four-year period consisting of the year involved and the three immediately preceding tax years or 2) during the four-year period on the basis of an aggregation of all pertinent amounts of income or assets held, received, or distributed during the four year period. See Tres. Reg. § 53.4942(b)-3(a) (1999).

The income test requires that a private operating foundation make qualifying distributions¹ directly for the active conduct of its exempt charitable activities. See I.R.C. § 4942(j)(3)(A) (1999). The distributions must equal substantially all² of 1) the lesser of its adjusted net income³ or 2) its minimum investment return.⁴

A foundation satisfies the asset test if substantially more than one half of its assets (at least 65%) is either 1) devoted directly to the active conduct of its tax-exempt activities, to functionally related businesses or to a combination of these functions, 2) stock of a corporation that is controlled by the foundation and substantially all of the assets of which are devoted to charitable activities, or 3) in part assets described in the first category and in part stock described in the second category. See Tres. Reg. § 53.4942(b)-2(a)(1) (1999). Assets include real estate, physical facilities or objects, and tangible assets. Property not included within the definition of assets, for the purpose of the asset test, are those held for the production of income, investment, or other similar use. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 11.1(b) (7th ed. 1998).

The endowment test is satisfied if the foundation expends its funds, in the form of qualifying distributions, directly for the active conduct of exempt activities. The foundation's distributions must equal at least two-thirds of its minimum investment return. See Tres. Reg. § 53.4942(b)-2(b)(1) (1999).

The support test consists of three prongs which all must be met. First, the foundation must receive all its support (other than gross investment income) from the general public and from at least five tax-exempt organizations that are not disqualified persons⁵. Second, not more than

¹ *See supra* Part II B(2) (defining qualifying distributions).

² Substantially all equals at least 85 %. *See* Tres. Reg. § 53.4942(b)-1(c) (1998).

³ Adjusted net income means any excess of a private foundation's gross income for a year over the sum of deductions allowed to a taxable corporation. *See* I.R.C. § 4942(f)(1) (1999); Tres. Reg. § 53.4942(a)-2(d)(1) (1999).

⁴ Minimum investment return means 5% of aggregate fair market value of all assets other than those used or held for use for the exempt purpose divided by the acquisition indebtedness with respect to such assets. *See* I.R.C. § 4942(j)(3) (1999).

⁵ A disqualified person is a person (or entity) that has a particular relationship with respect to a private foundation. *See* I.R.C. § 4946(a) (1999). A substantial contributor, one who contributes an aggregate amount of more than \$5,000 to the private foundation where that amount is more than 2 percent of the total contributions, is a disqualified person. *See* I.R.C. § 507(d)(2)(A) (1999). An exception to this rule is that a substantial contributor is not a disqualified person if after 10 years the person has no connection with the private foundation. *See* I.R.C. § 507(d)(2)(C) (1999). To qualify as having no connection with the foundation the person must not make any contributions for ten years, not be a foundation manager, and not be the significant contributor to the foundation in comparison to other donations received by the foundation. *See* I.R.C. § 507(d)(2)(C)(i)(III) (1999). Foundation managers, those who are officers, directors or trustees of a private foundation, are also a disqualified persons. *See* I.R.C. § 4946(b)(1) (1999). An owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the

25 percent of its support (other than gross investment income) may be received from any one of these exempt organizations. Third and finally, the foundation must not receive more than one-half of its support from gross investment income. See Tres.Reg. § 53.4942(b)-2(c)(1) (1999).

2. Exempt Operating Foundations

The second type of private operating foundation is the exempt operating foundation. The exempt operating foundation is classified as exempt because it does not have to pay the private foundation excise tax on investment income. See I.R.C. § 4940(d)(1) (1999). In addition, exempt operating foundation are not subject to the mandatory distribution requirement. See I.R.C. § 4945(d)(4)(A) (1999).

To qualify as a exempt operating foundation the foundation meet several requirements. First, it must qualify as a private operating foundation. Second, it must be publicly supported for at least 10 years. The publicly supported requirement is waived for organizations that qualified as an operating foundation as of January 1, 1983 or of its last taxable year ending before January 1, 1993. See Pub. L. No. 98-369, § 302(c)(3), 98 Stat. 494, 780-81 (1984). Third, its governing body must consist of individuals at least 75 percent of whom are not disqualified individuals⁶. Fourth, the foundation must be broadly representative of the general public. Finally, at no time during the year can the foundation have an officer who was a disqualified individual. See I.R.C. § 4940(d)(3)(A) – (e) & (d)(2) (1999). The significance of qualifying as a exempt operating foundation is that exempt operating foundations do not have to pay tax on undistributed income or an excise tax. See I.R.C. § 4942(a)(1) (1999).

II. Tax Liability for Private Foundations, Private Operating Foundations, and Exempt Operating Foundations

A. Basic Tax Structure

Private foundations and private operating foundations are taxed a 2 percent excise tax. Private foundations must also make mandatory distributions and are taxed if in violation of the distribution requirement. Both private operating foundations and exempt operating foundations are exempt from the mandatory distribution requirement. All foundations are subject to taxes for

beneficial interest of a trust or unincorporated enterprise who is a substantial contributor is also a disqualified person. See I.R.C. § 4946(a)(1)(C) (1999). Finally, any member of the family of an individual who is a substantial contributor, a foundation manager, or a 20 percent owner is a disqualified person. See I.R.C. § 4946(a)(1)(D) (1999).

⁶ A disqualifying individual is one who 1) is a substantial contributor to the foundation (aggregate gifts or bequeaths to the foundation as of the end of the taxable year exceed \$5,000 if such amount is more than 2 percent of the total gifts and bequests received by the foundation), 2) is an owner of more than 20 percent of the total combined voting power of a corporation, the profits interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise that is a substantial contributor to the foundation, or 3) a family member of any disqualified individual. See I.R.C. § 4940(d)(2)(D) (1999).

certain activities including self-dealing, maintaining excess business holdings, jeopardizing investments, and making certain taxable expenditures. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 11.4 (7th ed. 1998). Under the federal statutory scheme, each type of tax is sub-divided into three tiers: an initial tax, an additional tax, and an involuntary termination tax. See id. In general, if there is a violation of the tax code the foundation must pay the initial tax. See I.R.C. § 4941(a), 4942(a), 4943(a), 4944(a), 4945(a) (1999). An additional tax is levied if the initial tax is not timely paid and the matter is not timely corrected. See I.R.C. § 4941(b), 4942(b), 4943(b), 4944(a), 4945(a) (1999). The termination tax is imposed when the first two taxes have been imposed and there continues to be a willful, flagrant, or repeated violation. See I.R.C. § 507(a)(2) (1999).

B. Tax Classifications

1. Two Percent Excise Tax

Private foundations and private operating foundations must pay an annual 2 percent excise tax⁷ on the net investment income of the foundation, estimated and paid quarterly. See I.R.C. § 4940(a) (1999); Reg. § 53.4940-1(a) (1999). In a year in which the foundation's pay-out for charitable purposes is increased by 1 percent of its net investment income, the excise tax is reduced to a 1 percent tax. See I.R.C. § 4940(e)(1) (1999). Net investment income is defined as the amount by which the foundation's gross investment income⁸ and net capital gains⁹ exceed allowable deductions¹⁰.

Exempt operating foundations are exempt from this 2 percent excise tax. See I.R.C. § 4940(d) (1999). The purpose of the exemption was to "assist such public-involvement operating foundations in making direct expenditures for the active conduct of their charitable activities." See Taxation of Exempt Organizations § 6.01(1) (citing IRM 12(23)).

2. Violation of Mandatory Distributions

⁷ The excise tax's purpose is to impose a user fee on foundations to cover the administrative costs of regulating private foundations. See TAXATION OF EXEMPT ORGANIZATIONS, § 6.01(1)(citing The Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 498).

⁸ Gross investment income includes interest, dividends, rents, royalties, and payment with respect to security loans received by a private foundation from all sources during a taxable year, even if such amounts are derived from assets devoted to the foundation's charitable activities. See Tres. Reg. § 53.4940-1(d)(1) (1999).

⁹ Net capital gains include the excess of gains over losses from the sale or exchange of capital assets. See I.R.C. § 4940(c)(4)(A) (1999).

¹⁰ Allowable deductions include ordinary and necessary expenses incurred in producing or collecting income or managing the foundation's investment assets. See I.R.C. § 4940(c)(1) (1999).

Each year private nonoperating¹¹ foundations are required to distribute a minimum amount of money and/or property to charitable purposes. The purpose of the tax is to prevent unreasonable accumulations of income or assets used for noncharitable purposes. See H.R. Rep. No. 413, 91st Cong., 1st Sess. 1 (1969), reprinted in 1969-3 CB 200. Thus, the tax is structured to tax a certain percentage of the foundation's assets that are not used directly in carrying out the foundation's exempt purpose.

The foundation must make a certain amount of qualifying distributions¹². See I.R.C. § 4942 (1999). If the foundation fails to meet its required qualifying distributions, an initial tax of 15 percent is imposed upon undistributed income of a private foundation that has not been distributed before the first day of the taxable year. See I.R.C. § 4942(a). The minimum amount of qualifying distributions is called the distributable amount. The distributable amount is equal to the minimum investment return¹³ minus excise taxes and other foundation taxes for the taxable year plus 1) repayments of amounts previously treated as qualifying distributions, 2) amounts received or accrued from the sale or other disposition of property previously treated as qualifying distribution, and 3) amounts previously set aside for charitable purposes if the set-aside was treated as a qualifying distribution but is no longer necessary for the purposes for which the amounts were set aside. See I.R.C. § 4942(c)(1)-(2) &(d)(1)-(2) (1999); Tres. Reg. § 53.4942(a)-2(c)(1), 53.4942(a)-2(c)(5) (1999).

There are, however, exceptions to the tax burden imposed upon undistributed income. One mechanism for avoiding the 15 % tax is to qualify as an operating foundation. See I.R.C. § 4942(a)(1) (1999). Operating foundations are expressly excluded from the 15% initial tax on undistributed income. See I.R.C. § 4942(a)(1) (1999). If the foundation does not qualify as a

¹¹ Operating foundations include private operating foundations and exempt operating foundations.

¹² Qualifying distributions are grants, outlays for administration, and payments made to acquire charitable assets. See I.R.C. § 4942(g)(1) (1999); Tres. Reg. §§ 53.4942(a)-3(a), 53.4942(a)-3(c) (1999). They include 1) grants to public charities and private operating foundations that are not controlled by the grantor private foundation, and 2) direct expenditures for charitable purposes, which may include amounts paid for the foundation's administrative expenses and the acquisition of assets that will be used for charitable purposes. See I.R.C. § 4942(g) (1999). A set-aside may be regarded as a qualifying distribution. See Tres. Reg. § 53.4942(a)-3(b)(1) (1999). Through set-asides, funds are credited for a charitable purpose, rather than immediately granted. A foundation may utilize set-asides to offset distributions if they meet the suitability test, requiring a specific project with a payment period not to exceed 60 months and an IRS ruling, or if they meet the cash distribution test, which requires set percentages of distributions over multi-year periods with no IRS ruling. See I.R.S. § 4942(g)(2) (1999); Tres. Reg. § 53.4942(a)-3(b)(7)(i) (1999).

¹³ The minimum investment return equals 5 percent of the fair market value of the noncharitable assets of the foundation. See I.R.C. § 4942(d)(10), 4942(e)(1)(A) (1999); Tres. Reg. § 53.4942(a)-2(b)(1) (1999). "Charitable assets include assets actually used by the foundation in carrying out its charitable objectives or assets owned by the foundation where it has convinced the IRS that its immediate use for exempt purposes is not practical and that definite plans exist to commence a related use within a reasonable period." BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS*, § 11.4(b) (7th Ed. 1998). Thus, the income from assets held for income production or investment (stocks, bonds, interest-bearing notes, endowment funds, and leased real estate) is the income to be used to calculate the minimum investment return. See id. Any property that is not used for a charitable purpose may also be calculated as noncharitable assets for the purpose of calculating the minimum investment return.

operating foundation, the foundation may meet separate criteria, establishing that the foundation failed to distribute income solely because of incorrect valuation of assets, and avoid the initial tax. See I.R.C. § 4942 (a)(2) (1999). To prove incorrect valuation of assets the foundation must 1) prove the failure to value the assets properly was not willful and was due to reasonable cause, 2) distribute the qualifying distributions, 3) notify the Secretary of the distribution, and 4) treat the distribution as a distribution for the taxable year for which it should have been imposed. See I.R.C. § 4942(a)(2)(A)-(D) (1999).

If a private foundation fails to distribute the undistributed income at the close of the taxable year and is required to pay an initial tax of 15 %, then it is subject to an additional 100 % tax on undistributed income at the end of the taxable year if the initial tax has not yet been paid. See I.R.C. § 4942(b) (1999). Termination taxes will be imposed on the failure to abide by the initial and additional taxes. See I.R.C. § 507(a)(2) (1999).

3. Self-Dealing

The federal law prohibits self-dealing between a private foundation and a disqualified person. See I.R.C. § 4941 (1999). Self-dealing occurs when there is a sale or exchange of property between a private foundation and a disqualified person. For instance, if a private foundation assumes the mortgage on property owned by a disqualified person, that sale constitutes self-dealing. See I.R.C. § 4941(d)(1)(A) (1999); Tres. Reg. § 53.4941(d)-2(a)(2) (1999). Unless property is leased without charge, leasing property owned by a disqualified person to a foundation also constitutes self-dealing. See I.R.C. § 4941(d)(1)(A) (1999); Reg. § 53.4941(d)-2(b)(1) (1999). Similarly, lending of money, extension of credit, furnishing of goods, services or facilities, payment of compensation, and transfer of money between a disqualified person and a foundation are examples of self-dealing. See Bruce R. Hopkins, The Law of Tax-Exempt Organizations § 11.4(a) (7th ed. 1998).

For any violations of the self-dealing provision, an initial tax of 5 percent of the amount involved in the self-dealing for the year is imposed upon the self-dealer and a tax of 2 ½ percent is charged to the foundation manager where the manager knowingly participated in the act. See I.R.C. § 4941(e)(3) (1999); Tres. Reg. § 53.4941(e)-1(C) (1999). If the initial tax is not paid, an additional tax of 200 percent is charged to the self-dealer and a 50 percent tax (not to exceed \$10,000) is charged to the participating foundation manager. See I.R.C. § 4941(b)(1)-(2) & (c)(2) (1999); Tres. Reg. § 53.4941(b)&(c)-1(a)&(b) (1999). Repeated violations may result in loss of foundation status and imposition of termination tax provisions. See I.R.C. § 507(a)(2) (1999).

4. Maintaining Excess Business Holdings

Federal tax law limits the amount of commercial business interest that may be owned by a foundation to no more than 20 percent of the business' voting stock or other interests. See I.R.C. §§ 4943(c)(2)(A), 4943(c)(3) (1999); Reg §§ 53.4943-1, 53.4943-3 (1999). If a private foundation maintains excessive business holdings, it has five years to reduce the holdings to a permissible level without penalty. See I.R.C. § 4943(c)(6) (1999). The initial tax for violation is

equal to 5 percent of the total value of all the foundation's excess business holdings. See I.R.C. § 4943(a)(1); Reg. § 53.4943-2(a)(1) (1998). The additional tax is equal to 200 percent of the holdings and termination taxes are imposed if the additional tax fails to compel compliance. See I.R.C. §§ 4943(b), 507(a)(2) (1999).

5. Jeopardizing Investments

The foundation managers must invest both income and the principal by exercising ordinary business care and prudence. See I.R.C. § 4944 (1999); Tres. Reg. § 53.4944-1(a)(2)(i) (1999). Failure to exercise ordinary business care and prudence in investing would lead to an initial tax of 5 percent of the amount invested for each year. See I.R.C. § 4944(a)(1) (1999). An additional tax of 25 percent of the investment and subsequent termination taxes may also be imposed. See I.R.C. § 4944(a)(2) (1999); Tres. Reg. § 53.4944-1(b) (1999).

6. Making Certain Taxable Expenditures

A taxable expenditure is an expenditure that the federal statute prohibits foundations from making, such as expenditures on legislative activities, electioneering, grants to individuals, and grants to noncharitable organizations. See I.R.C. § 4945 (1999). If such expenditures are made, a 10 percent excise tax on the amount of the expenditure is imposed on the foundation and a 2 ½ percent excise tax on the amount of the expenditure is imposed on the participating foundation manager. See I.R.C. § 4945(a)(1) (1999); Tres. Reg. § 53.4945-1(a)(1) (1999) An additional tax of 100 percent of the expenditure may be imposed on the private foundation and 50 percent on the foundation manager. See I.R.C. § 4945(b)(2) (1999); Tres. Reg. § 53.4945-1(c)(1) (1999). Finally, termination tax provisions may be applied if the foundation continues to violate this provision.