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
Why this Presentation?

- 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

- Public Charities
  - 509(a)(1)
  - 509(a)(2)
- 509(a)(3) Supporting Organizations
  - Type I
  - Type II
  - Type III
- Private Foundations
  - Operating
  - Grant-making
  - Type I
  - Type II
  - Type III
  - FI
  - NFI
Basic Definitions
Foundation Excise Taxes

• **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></td>
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<td><strong>Private</strong></td>
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<tr>
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<td><strong>Foundation</strong></td>
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<tr>
<td></td>
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<td><strong>Managers</strong></td>
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<td></td>
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<td></td>
<td><strong>Tax</strong></td>
</tr>
<tr>
<td>4940</td>
<td>Investment income tax</td>
<td>X</td>
<td>1% - 2%</td>
</tr>
<tr>
<td>4941</td>
<td>Self-dealing</td>
<td>Self-dealer</td>
<td>10%-200%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Foundation</td>
<td>5%-50%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>manager</td>
<td></td>
</tr>
<tr>
<td>4942</td>
<td>Undistributed income</td>
<td>X</td>
<td>30% -100%</td>
</tr>
<tr>
<td>4943</td>
<td>Excess business holdings</td>
<td>X</td>
<td>10% - 200%</td>
</tr>
<tr>
<td>4944</td>
<td>Jeopardizing investments</td>
<td>X</td>
<td>10%-25%</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>4945</td>
<td>Taxable expenditures</td>
<td>X</td>
<td>20% - 100%</td>
</tr>
<tr>
<td></td>
<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
Proper Procedures for Grants to Foreign Organizations

• **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)
• 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
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
990-PF Common Errors

Distributions

• 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
990-PF Common Errors – The Form

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
<table>
<thead>
<tr>
<th>Part VI</th>
<th>Excise Tax Based on Investment Income (Section 4940(a), 4940(b), 4940(c), or 4940) see instructions</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) State operating foundations described in section 4940(b)(2), enter here:</td>
<td>49,877</td>
</tr>
<tr>
<td>b) Domestic foundations that meet the section 4940(e) requirements in Part V:</td>
<td>65,247</td>
</tr>
<tr>
<td>c) All other domestic foundations enter 2% of line 2: Exempt foreign organizations or 4% of Part I, line 2, col. (8), enter here:</td>
<td>7,500</td>
</tr>
<tr>
<td>d) Tax under section 511 (domestic section 4947(a)(1) trusts and taxable foundations only, Others enter 0):</td>
<td>49,877</td>
</tr>
<tr>
<td>e) Tax on investment income. Subtotal line 4 from 1 to 3 if less or 0 enter:</td>
<td>49,877</td>
</tr>
<tr>
<td>f) Total: Add lines 1 and 2:</td>
<td>65,247</td>
</tr>
<tr>
<td>g) Total: Add lines 10 through 12:</td>
<td>72,747</td>
</tr>
<tr>
<td>h) Enter any penalty for underpayment of estimated tax. Check here:</td>
<td>22,870</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part VII-A</th>
<th>Statements Regarding Activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) During the tax year, did the foundation attempt to influence any national, state, or local legislation or did it participate or intervene in any political campaign?</td>
<td></td>
</tr>
<tr>
<td>b) Did it spend more than $500 during the year (either directly or indirectly) for political purposes (see instructions for definition)?</td>
<td></td>
</tr>
<tr>
<td>c) If the answer is &quot;yes&quot; to a) or b), attach a detailed description of the activities and copies of any materials published or distributed in connection with the activities.</td>
<td></td>
</tr>
<tr>
<td>d) Did the foundation file Form 1120-POL for this year?</td>
<td></td>
</tr>
<tr>
<td>e) Enter the amount (if any) or tax on political expenditure (nascient 1545) imposed during the year:</td>
<td></td>
</tr>
<tr>
<td>f) On the foundation:</td>
<td>0</td>
</tr>
<tr>
<td>g) On the foundation manager:</td>
<td>0</td>
</tr>
<tr>
<td>h) Enter the amount (if any) paid by the foundation during the year for political expenditure or imposed on foundation managers:</td>
<td>0</td>
</tr>
<tr>
<td>i) Has the foundation engaged in any activities that have not previously been reported to the IRS?</td>
<td></td>
</tr>
<tr>
<td>j) If &quot;yes,&quot; attach a description of the activities.</td>
<td></td>
</tr>
<tr>
<td>k) Did the foundation make any changes, not previously reported to the IRS, in its governing instrument, articles of incorporation, or bylaws, or other governing documents? If &quot;yes,&quot; attach a corrected copy of the charter.</td>
<td></td>
</tr>
<tr>
<td>l) Did the foundation have unrelated business gross income of $1,000 or more during the year?</td>
<td></td>
</tr>
<tr>
<td>m) Has it filed a tax return on Form 990-PF for this year?</td>
<td></td>
</tr>
<tr>
<td>n) If &quot;yes,&quot; attach the statement required by General Instruction T.</td>
<td></td>
</tr>
<tr>
<td>o) Are the requirements of section 502(e) (relating to sections 4941 through 4943) satisfied?</td>
<td></td>
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<tr>
<td>p) By language in the governing instrument, or</td>
<td></td>
</tr>
<tr>
<td>q) By state legislation that effectively amends the governing instrument so that no mandatory directors, that conflict with the state law remain in the governing instrument?</td>
<td></td>
</tr>
<tr>
<td>r) Did the foundation have at least $5,000 in assets at any time during the year? If &quot;yes,&quot; complete Part II, col. (8), and Part XV.</td>
<td></td>
</tr>
<tr>
<td>s) Enter the amount (if any) paid to the foundation and/or where it is located (see instructions):</td>
<td></td>
</tr>
<tr>
<td>t) If the answer is &quot;yes&quot; to line 11, has the foundation furnished a copy of Form 990-PF to the Attorney General (or designate):</td>
<td></td>
</tr>
<tr>
<td>u) Each state as required by General Instruction C of Form 990-PF.</td>
<td></td>
</tr>
<tr>
<td>v) Did any persons become substantial contributors during the tax year? If yes, attach the names and addresses of the persons.</td>
<td></td>
</tr>
</tbody>
</table>

- **Tax on net investment income**
- **Potential taxable expenditure for political activities**
- **By-law changes**
- **File with state AG**
- **Substantial contributor disclosure**
<table>
<thead>
<tr>
<th>Part VII-A Statements Regarding Activities (continued)</th>
</tr>
</thead>
<tbody>
<tr>
<td>11. 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 &quot;Yes,&quot; attach schedule (see instructions)</td>
</tr>
<tr>
<td>12. Did the foundation make a distribution to a donor advised fund over which the foundation or a disqualified person had advisory privileges? If &quot;Yes,&quot; attach statement (see instructions)</td>
</tr>
<tr>
<td>13. Did the foundation comply with the public inspection requirements for its annual returns and exemption application?</td>
</tr>
</tbody>
</table>

**Foundation ownership of a controlled entity**

**Transfers to a donor advised fund**

**Public inspection requirements**

Make sure this is really “no”: FBAR may be needed
### 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? **No**
- Borrow money from, lend money to, or otherwise extend credit to (or accept it from) a disqualified person? **No**
- Furnish goods, services, or facilities to (or accept them from) a disqualified person? **No**
- Pay compensation to, or pay or reimburse the expenses of, a disqualified person? **Yes**
- Transfer any income or assets to a disqualified person (or make any of either available for the benefit or use of a disqualified person)? **No**
- Agree to pay money or property to a government official? **No**

If the foundation agreed to make a grant to or to employ the official for a period after the foundation's termination date: **No**

If any answer is "Yes" to 1a(1)-6, 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)? **No**

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

If "No," list the years.

#### 2b. 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**

#### 3a. Did the foundation hold more than a 2% direct or indirect interest in any business enterprise at any time during the year? **No**

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, 1999; (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 990-PF, 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 purposes? **No**

If the foundation made 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? **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
Planning Tips
1% v 2%

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)
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