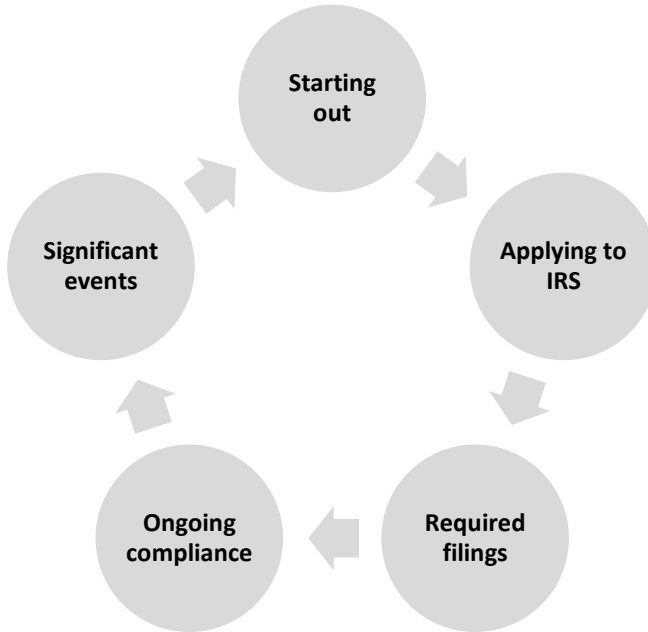


Private Foundations

LIFE CYCLE OF PRIVATE FOUNDATION

There are five steps to the lifecycle of a Private Foundation. They include



Tabular representation of Life Cycle of a Private Foundation is shown below.

Summary	Detailed steps
Starting out:	<ul style="list-style-type: none"> • Types of foundation <ul style="list-style-type: none"> ▪ Private operating foundations ▪ Exempt operating foundations ▪ Grant making foundations • Organizing documents <ul style="list-style-type: none"> ▪ Required provisions ▪ Sample organizing documents • By laws <ul style="list-style-type: none"> ▪ Required provisions ▪ Sample organizing documents • Acquire an Employer Identification Number <ul style="list-style-type: none"> ▪ Application form ▪ Apply for EIN on line

Summary	Detailed steps
	<ul style="list-style-type: none"> • Charitable Registration and Solicitation <ul style="list-style-type: none"> ▪ Initial state registration ▪ Periodic state reporting ▪ State charity offices • Help from IRS
Applying to IRS	<ul style="list-style-type: none"> • Requirements for exemption • Application Forms <ul style="list-style-type: none"> ▪ Exemption Application (Form 1023) ▪ Form 1023 instructions ▪ User fee ▪ Power of Attorney ▪ Disclosure of applications • Help from the IRS <ul style="list-style-type: none"> ▪ Application process step by step ▪ Customer account services ▪ Publication 4220 applying for 501(c)(3) tax exemption Status ▪ Publication 557, tax exempt status for the organization • IRS Processing <ul style="list-style-type: none"> ▪ Tax Compliance before exempt status is recognized ▪ Rulings and Determination letters
Required Filings	<ul style="list-style-type: none"> • Annual exempt organization returns <ul style="list-style-type: none"> ▪ Requirements for filing ▪ Power of Attorney • Unrelated business income tax • Requirements for filing <ul style="list-style-type: none"> ▪ Form 990 T ▪ Form 990 T instructions ▪ Estimated tax <ul style="list-style-type: none"> ◦ Form 990-W ▪ Exceptions and exclusions ▪ Publication 598, <i>tax on unrelated business income</i> <ul style="list-style-type: none"> ◦ for exempted organizations • Employment taxes <ul style="list-style-type: none"> ▪ Requirement to pay ▪ Exceptions and exclusions ▪ Worker classification ▪ Employment tax forms ▪ Employment tax publications • Help from the IRS

Summary	Detailed steps
	<ul style="list-style-type: none"> ▪ Customer account services ▪ Publication 4221-PF applying for 501(c)(3) private foundation ▪ Publication 557, tax exempt status for the organization
Ongoing Compliance	<ul style="list-style-type: none"> • Jeopardizing exemption <ul style="list-style-type: none"> ▪ Inurement/private benefit ▪ Lobbying and political activity ▪ Not filing requirement annual return • Private Foundation Excise taxes <ul style="list-style-type: none"> ▪ Tax on net investment income ▪ Self-dealing ▪ Failure to distribute income ▪ Excess business holdings ▪ Jeopardising investments ▪ Taxable expenditures • Substantiation and disclosure <ul style="list-style-type: none"> ▪ Charitable contributions <ul style="list-style-type: none"> ◦ Charitable contributions (publication 1771) ◦ Written acknowledgements ◦ Quid Pro Quo contributions ◦ Charity auctions ▪ Non cash contribution <ul style="list-style-type: none"> ◦ Donor (Form 8283) ◦ Charity (Form 8282) ◦ Publication 561 (<i>Determining the value of donated Property</i>) • Public disclosure requirements • Retirement plan compliance • Help from the IRS <ul style="list-style-type: none"> ▪ Customer account services ▪ Compliance code (<i>Publication 4221 – PC</i>) ▪ Tax exempt status of the organization (<i>Publication 557</i>)
Significant events	<ul style="list-style-type: none"> • Reporting changes to IRS <ul style="list-style-type: none"> ▪ Termination of exempt organizations • Private letter rulings and determination letters • Audits of exempt organizations <ul style="list-style-type: none"> ▪ Potential examination consequences ▪ Examination procedures ▪ Power of Attorney • Termination of an exempt organizations

Summary	Detailed steps
	<ul style="list-style-type: none"> • Help from the IRS <ul style="list-style-type: none"> ▪ Customer Account services ▪ Compliance code (<i>Publication 4221 – PC</i>) ▪ Tax exempt status of the organization (<i>Publication 557</i>)

EXCISE TAX PROVISIONS AFFECTING PRIVATE FOUNDATIONS

The following provisions were in response to concerns over contributed assets, concerns that officers and directors used assets in a manner that benefited individuals rather than charitable programs, and concerns over the imprudent management of foundation assets and use of foundation assets for non-charitable purposes.

CODE SECTION 4940: EXCISE TAX ON INVESTMENT INCOME

Section 4940 imposes an annual excise tax of 2% on the net investment income of private foundations. The purpose of this excise tax is to cover the Internal Revenue Service’s administrative costs in auditing and monitoring private foundations. To encourage further charitable giving, this excise tax is reduced to 1% where the foundation increases its annual distributions for charitable purposes beyond the mandatory minimum described in section II.C. below. Tax rules provide a formula, based on a rolling average of distributions and net investment income, which is a prerequisite for the 1% rate. Net investment income generally includes interest, dividends, rents, royalties and capital gain net income.

A private foundation must make quarterly estimated tax payments of the excise tax on investment income if it expects its tax liability to be \$500 or more. For years in which the private foundation’s Section 4940 tax is not expected to exceed \$500, it may pay the tax upon filing its annual information return, the Form 990-PF.

CODE SECTION 4941: SELF-DEALING

Section 4941 imposes an excise tax on each act of self-dealing between a “disqualified person” and a private foundation. Disqualified persons include trustees, directors, foundation managers, substantial contributors to the foundation and certain family members of the above, as well as government officials at certain levels.

Disqualified persons are defined as under:

- (i) foundation managers and their families (“foundation manager” being a term with a specific meaning under the Code, but one that includes officers and directors);

- (ii) substantial contributors (also a term with a specific meaning under the Code) and their families;
- (iii) individuals who own more than 20 percent of the total combined voting power of a corporation, the profit interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, any of which is a substantial contributor to the private foundation, and their families;
- (iv) corporations, partnerships, trusts and estates in which disqualified persons hold more than 35 percent of the ownership or beneficial interest; and
- (v) government officials (although not their families). Family members are spouses, ancestors, children, grandchildren, great-grandchildren, as well as spouses of children, grandchildren and great-grandchildren.

The statutory definition of self-dealing is quite broad and includes the following:

1. the sale, exchange or leasing of property;
2. lending of money or extensions of credit (other than the lending of money to a private foundation on an interest-free basis);
3. furnishing of goods, services, or facilities (other than by a disqualified person at no charge to the foundation);
4. payment of unreasonable compensation; and
5. transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the foundation.

There is an important exception to these rules that allows a private foundation to pay a disqualified person reasonable compensation for services rendered in connection with carrying out the activities of the foundation. However, there is no exception from the prohibition on acts of self-dealing for inadvertent violations, and even transactions which clearly benefit the foundation may be subject to tax as an act of self-dealing. For example, a disqualified person may not rent space to a private foundation, even at a below-market rate.

Self-dealing excise taxes are imposed on the disqualified person who has engaged in the self-dealing transaction and on any foundation manager who knowingly participates in the transaction. The tax liabilities under Section 4941 are imposed on a two tier system. At the first level, disqualified persons are taxed at a rate of 10% of the “amount involved” in the act of self-dealing. Foundation managers are taxed at a rate of 5% of the amount involved (up to a maximum of \$20,000 per act). Where the self-dealing transaction involves the use of money (i.e., a loan) or other property, the “amount involved” generally means the greater of the amount paid for the use of the property or fair market value for the period for which the money or other property is used. Thus, for example, if a private foundation leases space from a disqualified person, the amount involved is the greater of the amount of rent

received by the disqualified person from the foundation or the fair rental value of the building for the period the foundation uses the building.

A second tier of taxes is imposed at much higher rates where an act of self-dealing has occurred and is not undone within a certain specified period of time. The rate imposed on a disqualified person who fails to correct the act of self-dealing is 200% of the amount involved, and the rate imposed on foundation managers is 50% of the amount involved (capped at \$20,000).

CODE SECTION 4942: MANDATORY DISTRIBUTIONS

To ensure that foundations distribute assets for charitable purposes each year, Section 4942 requires a private foundation to make annual “qualifying distributions” in an amount equal to or greater than 5% of its net investment assets. The amount that a foundation must distribute is calculated annually; however, the foundation has two years in which to make qualifying distributions of that amount – the year for which the distributable amount is calculated and the subsequent year.

Qualifying distributions generally include grants to public charities, other than certain “supporting organizations,” and direct expenditures for charitable purposes, including administrative expenses associated with the conduct of the foundation’s charitable activities and for the acquisition of assets that will be used for charitable purposes. Amounts set aside for future long-term charitable purposes also may be treated as qualifying distributions if certain conditions are met.

If a foundation distributes more than is necessary to meet its distribution requirements in a given year, those excess qualifying distributions can be carried forward to reduce the distributable amounts in the following five years. For example, assume that a private foundation has distributable amounts for 2014, 2015 and 2016 of \$1,000 each year. It makes no qualifying distributions in 2014 and it makes a qualifying distribution of \$2,500 in 2015. The 2015 distribution will satisfy the \$1,000 distribution requirements for 2014 and 2015. Moreover, the foundation will carry forward the \$500 excess qualifying distribution to apply to its distributable amounts for the years 2016 through 2020.

Failure to comply with the distribution requirement results in an initial penalty tax of 30% of the foundation’s undistributed income (the amount which should have been, but was not, paid out). The foundation will receive notice of its failure to meet the distribution requirement and will have 90 days to correct the problem by making additional qualifying distributions. If the foundation does not make the corrective qualifying distributions in a timely manner, Section 4942 imposes an additional tax of 100% of the amount remaining undistributed.

CODE SECTION 4943: EXCESS BUSINESS HOLDINGS

Section 4943 prohibits a private foundation from owning more than specified equity interests in business enterprises including corporations, partnerships, estates or

trusts. This provision was enacted out of concern that significant ownership in a business might divert foundation assets and attention from their intended charitable purposes.

While the rules are fairly complex, a private foundation, together with all disqualified persons, generally may not hold more than 20% ownership in a business enterprise. The limit increases to 35% if effective control of the business is in the hands of one or more persons who are not disqualified persons. These rules do not apply if the foundation owns less than 2% of a business or if the business engages in activities that are substantially related to the foundation's charitable purposes. Since it can be difficult to track the equity holdings of all disqualified persons, many foundations avoid the application of the excess business holding rules by not exceeding 2% ownership of any business.

If a foundation acquires business holdings other than by purchase (e.g., by gift or bequest), and the additional holdings would result in the foundation having excess business holdings, the foundation effectively has five years to reduce those holdings to permissible levels. The IRS can allow an additional five-year period for the disposition of excess business holdings in the case of an "unusually" large gift or bequest.

The initial tax imposed on a foundation with excess business holdings is 10% of the value of such holdings during the taxable year. The amount of the excess holdings is determined as of the day during the tax year when the foundation's excess holdings in a business enterprise were the greatest. If the foundation fails to divest itself of the excess holdings within a certain period of time, there is an additional tax of 200% of their value.

CODE SECTION 4944: JEOPARDY INVESTMENTS

Section 4944 prohibits a private foundation from investing its charitable assets in an imprudent manner. To ensure that investments do not jeopardize the ability of the organization to accomplish its exempt purposes, the regulations provide that:

An investment shall be considered to jeopardize the carrying out of the exempt purpose of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

No category of investments is a *per se* violation of Section 4944, but certain types of investments will be closely scrutinized by the IRS (trading in securities on margin, trading in commodities futures, buying puts, calls and straddles, selling short, etc.).

Section 4944 does not apply to an investment that is contributed to a private foundation. However, there may be fiduciary and investment management concerns

that would compel a foundation to dispose of some property acquired by gift, such as to provide for greater diversification. There is also an exception from Section 4944 for investments that qualify as “program-related” investments for which the primary purpose is to achieve a charitable objective rather than to produce income. For example, a foundation may be able to further its charitable purpose of improving an economically depressed area by making loans to local corporations when commercial financing is unavailable.

An initial tax of 10% of the amount of the investment is levied on the foundation for any violation of Section 4944. In addition, a 5% tax (up to a maximum of \$10,000) may be imposed on the foundation managers. A second-level tax of 25% may be imposed on the foundations (5% for the foundation managers, up to a maximum of \$25,000) if the jeopardy situation is not corrected within a certain period.

CODE SECTION 4945: TAXABLE EXPENDITURES

Finally, Section 4945 places a series of restrictions on types of grants that private foundations may make.

It defines the “taxable expenditures” as under:

- any amount paid or incurred to engage in lobbying activities;
- any expenditure to influence the outcome of any specific public election or to conduct a voter registration drive or voter education activities;
- any grant to an individual for travel, study, or other similar purpose, unless (1) the grant is awarded on an objective and nondiscriminatory basis, and (2) the grant is made pursuant to a procedure approved in advance by the IRS;
- any grant to an organization other than a public charity or exempt operating foundation, unless the grant is for charitable purposes and the grantor foundation exercises “expenditure responsibility” with respect to the grant to ensure that it is spent solely for the purposes for which it was made; and
- Any amount paid or incurred for any non-charitable purpose, other than expenditures to acquire investments to produce income that will be used in furtherance of charitable purposes.

Section 4945 imposes a first-tier tax of 20% of each taxable expenditure on the private foundation. In addition, a 5% first-tier tax (up to a maximum of \$10,000) is imposed on private foundation managers. Failure to correct the expenditure in a certain period of time will result in the imposition of a second-tier of tax: 100% of the amount of the expenditure on the foundation and 50% (up to a maximum of \$20,000) on foundation managers.

REPORTING AND DISCLOSURE REQUIREMENTS FOR PRIVATE FOUNDATIONS

All private foundations must file an annual information return, Form 990-PF, with the IRS. The Form 990-PF requires, among other things, information about the foundation's gross income for the year; information about expenses attributable to such income; information about disbursements for exempt purposes; information about total contributions and gifts received and the names of all substantial contributors; names, addresses, and compensation of officers and directors; an itemized statement of securities and all other assets at the close of the year; and an itemized statement of all grants made or approved. The Form 990-PF must be filed on the 15th day of the 5th month following the close of the foundation's accounting period. The IRS permits extensions of up to six months after the due date for the Form 990-PF, including an automatic three month extension.

Private foundations are required to comply with requests made in person or in writing by individuals who would like a copy of the foundation's Form 990-PF for any of the foundation's three most recent taxable years. Upon receiving such a request, the foundation is required to supply copies without charge other than a reasonable fee for copying and mailing costs. If the request is made in person at the foundation's principal place of business, the foundation must supply the copies immediately. If the request is made in writing, then copies must be provided within 30 days.

CONCLUSION

The private foundation rules in Sections 4940-4945 – and the self-dealing rules of Section 4941 and the taxable expenditure rules of Section 4945 in particular explained above are meant to provide an overview of how the various rules work in order to allow foundation managers to consider when a grant or expenditure may raise self-dealing or taxable expenditure concerns.