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# Private Foundations and Alternatives

# Charitable Vehicles

Private  
Foundations

## Public Charities

- 509(a)(1) / 509(a)(2)
- 509(a)(3) Supporting Organizations

Donor-Advised  
Funds

501(c)(4) Social  
Welfare  
Organizations

“Zuckerberg” LLCs

# Types of 501(c)(3) Organizations

## Public Charities

- 509(a)(1) (PC)
  - Churches - 170(b)(1)(A)(i)
  - Schools - 170(b)(1)(A)(ii)
  - Hospitals - 170(b)(1)(A)(iii)
  - Publicly supported organizations - 170(b)(1)(A)(vi)
- 509(a)(2) (PC)
- 509(a)(3) (Supporting Organizations)
  - Types I, II, and III Functionally Integrated (SO or SOUNK)
  - Type III Non-Functionally Integrated (SONFI or SOUNK)

## Private Foundations (PF)

- Private Operating Foundations (POF)

## 4947(a)(1) Trust

# Private Foundations

➤ **Must comply with all 501(c)(3) rules**

➤ **In addition, extra rules under Chapter 42**

<b>IRC 4940</b>	Excise Tax on Net Investment Income (1.39%)
<b>IRC 4941</b>	Self-Dealing (Transactions with Disqualified Persons) <ul style="list-style-type: none"><li>• Most financial transactions forbidden (but compensation okay if reasonable, necessary and not excessive, and for “personal services”)</li><li>• Direct or indirect benefits</li></ul>
<b>IRC 4942</b>	Minimum Distribution Requirements <ul style="list-style-type: none"><li>• Private Operating Foundations</li></ul>
<b>IRC 4943</b>	Excess Business Holdings Limitations
<b>IRC 4944</b>	Jeopardizing Investments
<b>IRC 4945</b>	Taxable Expenditures (special rules for distributions to individuals and to non-charities; no lobbying or political expenditures)

# History of Related-Party Transaction Rules for Charities

## 1969 Tax Code – Joint Committee on Taxation

- Arms'-length standards of IRC 503 hard to enforce, with uncertain effectiveness
- Sanctions (loss of exemption) often disproportionate, making agents reluctant to enforce
- Subjectivity in applying arms'-length standards
- Arms'-length standards don't go far enough in preventing improper use of foundation assets
  - PF purchasing property at fair value where founder needs cash now and can't find ready buyer
  - Lending money to donor with adequate interest and security but where money market is too tight to find ready alternative funds
  - Commitments to lease property from donor at FMV where donor needs advance leases to secure financing for acquisition/construction

# History of Related-Party Transaction Rules for Charities

## Split approach in current tax code

<b>All Charities:</b>	Private inurement / private purpose
<b>Public Charities:</b>	“Intermediate Sanctions” rules of IRC 4958 (1996)
<b>Private Foundations:</b>	“Self-dealing” rules of IRC 4941 (1969) <ul style="list-style-type: none"><li>• Fixed standards, not dependent on subjective arms’ length determinations (in theory), more practical to enforce</li><li>• “This is based on the belief by the Congress that the highest fiduciary standards require complete elimination of all self-dealing rather than arms’-length standards”</li><li>• Avoids temptation to misuse PF funds for private purposes</li><li>• Does not rely on showing detriment – applies even if benefit to PF</li><li>• Specific list of transactions, broadly construed (“self-dealing” is a “comprehensively-defined term”)</li></ul>

# IRC 4941 – Self-Dealing – General Principles

Assume all direct or indirect financial transactions between a DP and a PF are forbidden

- IRC 4941 includes six specific categories of self-dealing, but they are broadly construed
- Don't focus on detriment or benefit, unless that is expressly part of the self-dealing test
- If relying on exception, expect it to be strictly construed
  - Generally, DPs can provide stuff for free, but even then must be used for PF's charitable purposes
  - Generally, PFs can provide stuff to DPs if on same terms as to general public and in furtherance of PF's charitable purposes

Remember that other provisions applicable to charities continue to apply to PFs

- Prohibition of private inurement
- Disqualification if serving a private purpose

# Self-Dealing Transactions

**Sale or Exchange, or  
Leasing, of Property -  
4941(d)(1)(A)**

**Lending of Money or  
Other Extension of Credit  
– 4941(d)(1)(B)**

**Furnishing of Goods,  
Services, or Facilities –  
4941(d)(1)(C)**

**Payment of  
Compensation or  
Payment or  
Reimbursement of  
Expenses – 4941(d)(1)(D)**

**Transfer to, or Use by or  
for the Benefit of, a  
Disqualified Person –  
4941(d)(1)(E)**

**Payments to Government  
Officials – 4941(d)(1)(F)**



# What Individuals Need to Worry About Self-Dealing?

## Disqualified Persons – IRC 4946

### Substantial contributors

(includes creator, even if not contributor)

- If entity is contributing, anyone owning more than 20% voting/profits/beneficial interest in entity

### Foundation Managers

Can include certain senior employees with “officer-like” responsibility”

### Family Members

Ancestors, descendants (to GGC’s), spouses of all

- *Tip:* Siblings, aunts and uncles, cousins, etc. NOT included

### 35% Entities

- Corporations – if DPs have more than 35% voting power
- Partnerships – if DPs have more than 35% profits interest
- Trusts/Estates – if DPs have more than 35% beneficial interest
- *Tip:* Estate NOT automatically a DP just because decedent was

# What Entities Need to Worry About Self-Dealing?

- **Private Foundations**
  - **IRC 4947(a)(1) Trusts**
  - **IRC 4947(a)(2) Split-Interest Trusts**
    - **Charitable Remainder Trusts**
    - **Charitable Lead Trusts**
  - **Estates** and certain **trusts** to the extent of PF expectancies
- **Entities controlled by private foundations**
    - Not just more than 50% voting
      - PF control: Ability to require entity to enter into self-dealing, or to veto decision that results in self-dealing
      - DP control: If DP's control, not the same as PF control, UNLESS DP's require PF participation to engage in the self-dealing transaction

# What Entities Need to Worry About Self-Dealing?

## Estate Example

- TPP to family (5% of assets)
- Vacation house to family trust (10% of assets)
- 20% of remaining assets to trusts for family
- Remainder (65%) to foundation

## Is Estate a disqualified person?

- No more than 35% beneficial interest for disqualified persons
- However, if residue to foundation, be wary of potential effect of taxes, debts, etc. reducing the foundation's share

# What Happens if I Commit Self-Dealing?

<b>Penalties on DP (1st-tier = 10%; 2nd-tier = 200%)</b>	No “reasonable cause” abatement
<b>Penalties on Foundation Manager (5%)</b>	Requires “knowing” violation; cap on liability
<b>Must determine when self-dealing act occurred</b>	Leasing, lending, use of property – new act of self dealing each year
<b>Must determine “Amount Involved”</b>	Generally greater of FMV at time of transaction and FMV at time of correction  Unless fair value is relevant factor (as with compensation, or certain corporate reorgs), “amount involved” is not reduced by amount paid by DP (although amount paid can reduce correction payments)

# What Happens if I Commit Self-Dealing?

<b>Must “correct” transaction</b>	<p>Generally involves undoing it to extent possible</p> <p>“[I]n any case placing the PF in a financial position not worse than that in which it would be if the DP were dealing under the highest fiduciary standards”</p> <p>Steps required depends on type of self dealing</p>
<b>Be wary – correction may be a new self-dealing transaction</b>	<p><i>Ex:</i> PF sells family owned company stock to DP. How to correct?</p> <ul style="list-style-type: none"><li>• Rescission? What if stock sold in meantime?</li><li>• What about appreciation? Greater of FMV at sale or at correction</li><li>• What about profits earned by DP while DP held the stock?</li></ul>

# Sale or Exchange or Leasing of Property

## Sale or Exchange

- Doesn't matter whether detrimental to PF or beneficial to DP
- **Any sort of exchange** qualifies
  - Ex., using appreciated property to repay interest-free loan
  - *Correction*: Purchase and transfer of “replacement” stock as misplaced correction.
- Transfer of **encumbered property** – treated as sale
  - Even if non-recourse
  - Exception for “old and cold” debt (at least 10 years old)
  - “First-bite” exception where DP status arises as a result of the transaction

**TIP:** Consider drafting wills to allow executor to establish new PF to receive encumbered property

# Sale or Exchange or Leasing of Property

## Sale or Exchange

- Beware **indirect sales**
  - Through controlled organizations
  - Through intermediaries
    - Ex., gift of real estate to public charity then sale by public charity to DP
    - Ensure no earmarking / pre-arrangement
    - Ensure no control by PF or DPs over granted assets
    - Ensure public charity board makes independent determination
    - If buying / leasing assets from DP, best if public charity can use separate funds (or make clear separate funds are available)
    - Anticipated use by public charity okay as long as truly independent determination

# Sale or Exchange or Leasing of Property

## Estate Administration Exception - Requirements

- **Power of Sale** (or power to reallocate property, or requirement to sell per option)
- **Court Approval**
- **Timeliness** – Must occur before estate terminated for federal income tax purposes (or before trust is considered subject to IRC 4947)
- **FMV of Consideration** (taking into account terms of pre-existing options)
- Consideration received by estate must be “**at least as liquid**” (or PF receives assets related to active carrying out of charitable purposes, or PF receives assets as required under terms of pre-existing option)

Consider option planning

Can you purchase for a note this way?



# Sale or Exchange or Leasing of Property

## Leases

- Anything other than **interest-free lease** is self-dealing
- What about **maintenance expenses**? Is that part of the lease?
  - Treas. Reg. 53.4941(d)-2(b)(2) – okay to require PF to pay for janitorial services, utilities, and other maintenance costs so long as they pay that directly to service providers, not to DP

# Lending of Money or Other Extension of Credit

## Anything other than interest-free loan from DP to PF is forbidden

- Even then, loan proceeds must be used exclusively for exempt purposes
  - Ex., PLR 9230001 – Interest-free loan self-dealing where loan proceeds used to place deposit on property which DP intended to use as personal residence

## PF can never lend money to DP

## Watch out for indirect lending

- Rev. Proc. 2021-40 – IRS will no longer issue rulings on whether receipt of a non-voting interest in an LLC that owns a promissory note issued by a DP is self-dealing.

# Furnishing of Goods, Services or Facilities

Anything other than free goods, services or facilities from DP to PF is forbidden

- Even then, must be used exclusively for exempt purposes

If goods, services or facilities from PF, must be provided to DP on same terms as everyone else and must be functionally related to foundation's charitable activities

- Operating foundation's newsletter
- Use of PF museum's private road for access to DP corporation facilities?
  - RR 76-459 – OK where general public allowed to use road as thoroughfare connected two public streets, and where use of road by public is functionally related to museum's purposes

**TIP:** If PF is providing services to DPs, either (1) ensure services are on same terms as general public, or (2) treat as compensation

# Compensation / Reimbursement of Expenses

**Exception for personal services which are reasonable and necessary to carrying out exempt purposes, and not excessive**

## Personal Services

- Brokerage
- Legal
- Investment counseling
- General administration (including programmatic and grantmaking services)
- General banking
- Services in defense of PF

## Professional and Managerial in Nature

*Madden* case (TC Memo 1997-395)

- Not available for contract with DP's company for general maintenance, janitorial, custodial services (not "professional")
  - But see PLR 7952117 (allowed reimbursement for maintenance services); PLR 9307026 (maintenance / security services qualified as "personal")

# Compensation / Reimbursement of Expenses

Exception for **personal services** which are **reasonable** and **necessary** to carrying out exempt purposes, and not **excessive**

- *Excessive* – Treas. Reg. 1.162-7 – in excess of what would ordinarily be paid for like services by like enterprises under like circumstances
- Review all cash and non-cash benefits (whether or not treated as compensation for income tax purposes) as compensation for self-dealing purposes
- **Compensation for past services** may be okay were in the nature of end-of-employment compensation (ex., pension awarded for past services) as long as reasonable in the aggregate – Rev. Rul. 74-591

# Compensation / Reimbursement of Expenses

## Reimbursement

Treat as interest-free loan?

- May be inconsistent with requirement in Reg's re maintenance payments for rent-free leases (must be paid directly, not to DP)

Treat as compensation for personal services rendered

- Focus on reason for reimbursement (in the nature of personal services furthering exempt purposes)

Advances:

- OK if reasonable in relation to duties – should ordinarily not exceed \$500

**TIP:** When providing benefits to DP, be sure to characterize as compensation from outset, and document both reasonableness and personal services performed

# Transfer to / Use By or FBO Disqualified Person

“Catch all” – not limited to examples in Regulations

Consider indirect as well as direct benefits to DP

- Access to capital if co-investing
- Reduced fees from PF participation

Displaying PF’s artwork in personal residence

Satisfaction of binding pledges

Payment by PF of Chapter 42 excise taxes (unless compensatory)

Purchase / sale of stock to manipulate price

Exception for incidental and tenuous benefit

- Reputation, or benefits flowing principally to general public

PF holding remainder interest in real estate? See PLR 200149040

# Payments to Government Officials

Generally any payment to government official is self-dealing

- “Government Official” is more limited than you might think
  - Elective public office (executive or legislative)
  - Appointed by President to executive/judicial branches
  - Certain other US gov’t positions (specified by class)
  - Position in US Congress with \$15k plus in compensation
  - State/local elective or appointive positions with \$20k plus in comp
  - Personal assistance / secretary of the foregoing

Various exceptions for prizes, awards, scholarships, etc.

Exception for payment of travel expenses solely within the US

- RR 76-159 – Trustee / gov’t official travel from Puerto Rico to US for foundation business not within exception



# Special Situations: Family Offices Sharing Resources

## Office Space

Provide to PF for free, or have PF pay third-party owner directly (no direct lease or reimbursement)

## Equipment

Provide to PF for free, or pay third-party separately

## Supplies

Provide for free or have PF collect its own supplies

## Employees

- Provide for free, or provide reimbursement for share of employees only for “personal services” and where reasonable, necessary and not excessive
- Beware personal services that are not “professional and managerial in nature” (e.g., janitorial)
- Fact that DP employer is relieved of part of comp “incidental/ tenuous”

**TIP:** Beware reimbursement arrangements – even if fair to charity, self-dealing if not within compensation exception

## *Special Situations:* Property Co-Ownership

- Not per se problematic
  - Beware of any benefit, direct or indirect, to DP
  - Manage carrying costs (ensure pro rata, or if DP is paying, per permitted rent-free arrangement)
  - If improvements / development needed, pro rata contribution problematic – if in nature of investment, consider partnership
- **However, use by DPs is problematic**
    - DP cannot just use it (Transfer to, or Use By of for the Benefit of, a DP)
      - Ex., use of co-owned artwork in DP's home forbidden
    - DP can't lease it
    - Only foundation can use it, and it should be used for foundation's exempt purposes (rent-free lease from DP to PF)

## *Special Situations: Co-Investing*

Priority guidance area

Concerns:

- Sale or exchange – getting in and getting out
- Compensation – Payment of management fees
- Use of PF assets by DP – Potential benefits to DPs from PF participation
  - Manipulation of value to benefit of DP
  - Greater access to investments
  - Reduced fees for DPs
  - PF helping satisfy DP's minimum investment requirements

Beware situation where PF may “control” investment vehicle

**TIP:** Get a PLR

# IRC 4941 – Self-Dealing – Key Takeaways

- ✓ Primary tax is on the DP – no abatement available
- ✓ Know your DPs – Many family members and entities are not DPs
- ✓ Don't need to show detriment to PF or benefit to DP – transaction is taxable unless clear exception
- ✓ No sales or leases, including transfer of encumbered property (Key exceptions: estate administration; corporate reorganizations; “first-bite” exception)
- ✓ No lending (unless for free by DP, to be used for charitable purposes)
- ✓ DPs can provide goods, services or facilities to DP for free, but must be used for PF's charitable purposes
- ✓ Compensation or reimbursements must be reasonable, necessary for PF's exempt purposes, not excessive, and for personal services
- ✓ Watch out for indirect benefits to DPs from PF assets (pledges; co-investing; family office)

# Overview

IRC 4942

Required

Distributions

- “Distributable amount”
- Non-qualifying distributions
- To other private foundations (potentially)
- To certain supporting organizations
- Distributions to DAFs
- Distributions to non-charities
- Distributions to foreign organizations
- “Stacking” of the 30% under-distribution penalties
- Private operating foundations

# What is My “Distributable Amount”?

## **Key point of confusion**

- The “distributable amount” for 2022 as calculated on the Form 990-PF is NOT the amount that you must distribute in 2022.
- Rather, it is the amount that you must distribute by the end of 2023.

## **First-year distributable amount**

- First year of foundation, or first year treated as a private foundation:
- Nothing needs to be distributed in that first year. Your “distributable amount” for Year 1 will be calculated on your Year 1 Form 990-PF, and must be distributed by the end of Year 2.

# Calculation of the Distributable Amount (2021)

## STEP 1

Calculate the “**Minimum Investment Return**” (2021 Form 990-PF, Part IX) – in other words, the fair market value of the PF’s assets

- Average monthly balance of public securities and cash
- For other assets, appraisal each year (or every five years for real estate with certified appraisal)
- Proration for partial initial year (if funded in late December, and calendar year filer, very little required distribution in first full tax year)

## STEP 2

Calculate the “**Distributable Amount**” (Part X)

- Reduce FMV base amount by 1.5% (cash deemed held for charitable purposes)
- Multiply remainder by 5%
- Reduce amount paid for 1% IRC 4940 tax (credit)
- Remainder is the “Distributable Amount” for 2021, which must be distributed by the end of 2022

# Calculation of the Distributable Amount (2021)

*Example:*

<b>Asset Value (Non-Charitable Use Assets)</b>	<b>\$10,000,000</b>
<b>Reduction for Cash Deemed Held for Charitable Purposes (1.5%)</b>	<b>-\$150,000</b>
<b><u>Subtotal</u></b>	<b>\$9,850,000</b>
<b>Multiply by 5%</b>	<b>\$492,500</b>
<b>Reduction for IRC § 4940 Excise Tax Paid (estimated)</b>	<b>-\$5,000</b>
<b>Distributable Amount</b>	<b>\$487,500</b>



# Ok, So How Much Must We Distribute in 2022?

*The 2021 “Distributable Amount” must be addressed either by **qualifying distributions** or by **qualified expenditures** (treated as qualifying distributions)*

**1** Determine “**carryforwards**” (over-distributions in past 5 year)

- These count towards satisfying the 2021 “Distributable Amount”

**2** Count **qualified expenditures** in 2022

- Must be reasonable and necessary for the accomplishment of the PF’s charitable mission
  - In general, investment/management expenses do not count (unless for management of charitable use assets)
- In practice, PF’s determine a reasonable allocation of overhead expenses and generally stick with that (may be subject to IRS challenge)
- Document methodology and reasons for allocation

**3** Count **qualifying distributions** in 2022

*See 2021 IRS Form 990-PF – Part XIII*

# What is a Qualifying Distribution?

- ✓ Distributions to **public charities** count (exception for distributions to Type III non-functionally integrated supporting organizations)
- ✓ **Program-related investments** count
- ✓ Distributions to **foreign organizations** count (expenditure responsibility or equivalency determination)
- ✓ Distributions to **other private foundations** count ONLY IF
  - Recipient PF re-distributes by end of its tax year following year of distribution AND
  - Recipient PF elects to treat those distributions as “out of corpus” (i.e., not counting towards the recipient’s own 5% distribution requirement)
- ✓ Distributions to **donor-advised funds** count
  - Note proposals in ACE Act, Biden Green Book, and IRS Notice 2017-73
- ✓ Distributions to **non-charities** count if for exclusively charitable purposes

# What Happens If We Don't Distribute?

30% penalty on the amount of the under-distribution

- Can happen because
  - Fail to make distribution
  - Distribution treated as not qualifying
  - Expenditure treated as not qualified
  - Asset undervalued or not reported

“Stacks” annually

# What Happens If We Don't Distribute? - *Example*

## Unreported asset worth \$10M (no appreciation)

Year	Calculation	Total
2014	5% of \$10,000,000 = \$500,000 under-distributed * 30%	\$150,000
2015	\$1,000,000 (original \$500k plus new \$500k) under-distributed * 30%	\$300,000
2016	\$1,500,000 under-distributed * 30%	\$450,000
2017	\$2,000,000 under-distributed * 30%	\$600,000
2018	\$2,500,000 under-distributed * 30%	\$750,000
2019	\$3,000,000 under-distributed * 30%	\$900,000
2020	\$3,500,000 under-distributed * 30%	\$1,050,000
2021	\$4,000,000 under-distributed * 30%	\$1,200,000

**Total tax: \$5,400,000**

# Private Operating Foundations

## Benefits:

- Avoids need to make 5% distribution
- Certain “public-charity” like tax benefits
  - 60% AGI limit
  - Full fair market deductions like public charities
  - DAFs can contribute

## However, still a private foundation, subject to all other private foundation rules

- So called “exempt operating foundation” (subset of POFs) may avoid IRC 4940 tax)

# Private Operating Foundations – How to Qualify

## *Must meet two tests*

### **Income Test – All POFs must satisfy**

- Spends at least 85% of base amount on direct charitable activities
- Base amount = lesser of adjusted net income and “minimum investment return” (FMV per IRC 4942 calculation)

### **Plus one of three alternate tests:**

- *Assets Test* – 65% or more of assets devoted directly to active charitable activities (special rules for subsidiaries)
- *Endowment Test* – Normally expends (direct charitable purposes) at least two-thirds of “minimum investment return” (FMV per IRC 4942 calculation) (i.e., about 3.33% of net asset value)
- *Support Test* – Broad sources of support, akin to public support test, not relying on too much investment income or too much support from one organization

# IRC 4942 – Required Distributions – Key Takeaways

- ✓ The “distributable amount” for a tax year is not the amount that you must distribute in that tax year (you have until the end of the following tax year)
- ✓ Be careful with valuations of assets, and do not omit assets
- ✓ Beware “stacking” of penalties; reasonable cause abatement vital for multi-year shortfalls
- ✓ Qualifying distributions: If to private foundation or Type III NFI, doesn't count (without extra steps)
- ✓ Qualified expenditures: Don't be too aggressive relying on overhead expenses as qualifying
- ✓ DAF grants do count – FOR NOW
- ✓ Consider private operating foundation status

# IRC 4943 – Excess Business Holdings – Overview

Business  
Holdings

Permitted  
Holdings

Gifts and  
Bequests

“Newman’s Own”  
Exception

Divestment of  
Excess Business  
Holdings



# What is a “Business Holding”?

## Active business interests not sufficiently related to charitable purposes

- *Purpose:* Prevent charities from having unfair commercial advantage over for-profit businesses
  - Unrelated business income tax rules do the same, but Congress went further for private foundations by prohibiting it entirely

## “Passive” business interests not prohibited

- Trade or business at least 95% of the gross income of which is derived from passive sources (IRC 4943(d)(3))
  - For year in question OR on average over prior 10 years

# When is a Business Holding “Excess”?

**Permitted holdings** = 20% of voting stock (or profits interests, if partnership; otherwise beneficial interests)

- *Voting stock* = voting for appointment of directors
- *Attribution Rules*: Reduced by voting stock owned by all DPs (IRC 4943(c)(2)(A))
- Review *indirect ownership* (via trusts, corporations, partnerships, etc.)
- *35% threshold* (instead of 20%) if:
  - PF and DP do not own more than 35% of stock
  - PF establishes to IRS satisfaction that non-DP’s have “effective control”
- Sole proprietorship – no permitted holdings
- Watch out for redemptions, etc. that change voting percentages

**De Minimis Rule**: No excess business holdings if PF owns no more than 2% of voting stock and no more than 2% in value of all outstanding shares of stock

**Non-voting shares**: “Excess” (not permitted) if DPs hold more than 20% of voting stock (Treas. Reg. 53.4943-3(b)(2)(i))

# Excess Business Holdings – Gifts and Bequests

If PF purchases excess business holding, **taxable immediately**

If received by **gift or bequest**, 5-year grace period to dispose of excess

- During grace period, deemed held by DPs
- May file PLR request to extend another 5 years if can demonstrate diligent efforts to dispose of holdings, and that disposition within initial period has not been possible (except at a price substantially below FMV) by reason of the size and complexity or diversity of the holdings
  - PF must submit to the IRS **and the state Attorney General** a plan for disposing of the interests in next five years

Voluntary increases in ownership after receipt not covered by grace period

Separately, 90-day grace period if acquired by other than purchase (starts when PF knew or should have know of excess holdings)

- Example, if holdings increased by corporate redemption of others
- May be extended to address securities law requirements

# What Does Salad Dressing Have to Do With It?

**“Newman’s Own” Exception – IRC 4943(g) – Rules don’t apply if:**

## Ownership:

- 100% of voting stock is held by PF at all times during taxable year
- All of PF’s interests were acquired by means other than purchase

## All Profits to PF

All income is distributed to the PF annually (see rules for allowable deductions, tax, and working capital reserves)

## Independent Operation

- No substantial contributor or family member is a director, officer, trustee, manager, employee or contractor of the business
- A majority of the PF board are not directors or officers of the business or family members of a substantial contributor
- No loans between business and substantial contributor (or family)

## Exception not available for

- DAFs
- SOs
- 4947 trusts

# What are the Penalties?

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- ! 10% tax on value of excess holdings (applied each year, if held at any time during the year)
- ! 200% “second-tier” tax if not disposed of within correction period
- ! Tax based on highest value during the period in which the foundation maintained its highest level of excess holdings

# How Do I Get Rid of This Excess Business Holding?

## *Sell it?*

- **NOT** to a disqualified person
- Is the Company a disqualified person? If so, no redemption by the company (unless within IRC 4941 corporate reorganization exception)

## *Donate it?*

- *To a DAF?* No, IRC 4943 applies to DAFs as well
- *To another private foundation?* Probably not – PF that is effectively controlled by same persons, or substantially funded by the same family, treated as “disqualified person” under special rule of IRC 4946(a)(1)(H)
- *To a public charity?*
  - > Can't give to certain supporting orgs (mainly Type III NFI)
  - > Can the public charity then sell it to the donor/family?
    - Maybe, if truly independent decision by public charity

# IRC 4943 – Excess Business Holdings – Key Takeaways

- ✓ Watch out for direct or indirect (via partnerships) holdings in active businesses
- ✓ Stay below 2% if possible. If not, stay below 20% (but beware aggregation rules)
- ✓ Applies to non-voting shares as well (if DPs hold more than 20% of voting)
- ✓ 5-year grace period only for gifts or bequests (not purchases)
- ✓ 90-day grace period once you knew or should have known of excess holdings
- ✓ Applies to DAFs, certain SOs, and certain 4947 trusts (including zeroed-out CLTs)
- ✓ Don't trigger self-dealing when disposing of excess holding

# IRC 4944 – Jeopardizing Investments

*10% tax on any investment that jeopardizes the carrying out of PF's exempt purposes*

- Happens when managers, in making the investment, have failed to exercise **ordinary business care and prudence** in providing for the **long- and short-term financial needs** of the PF to carry out its **exempt purposes**
- Determination made on investment-by-investment basis, but taking into account portfolio as a whole
- Look through entities to underlying investments in judging diversification and prudence
- Actual gain or loss not the test – rather, **prudence at the time of the investment**

**“Program-related investments”** excepted

**Doesn't apply to donated assets** (Treas. Reg. 53.4944-1(a)(2)(ii)), unless change to form or terms (but certain corporate reorganizations okay)

May consider foundation's charitable purposes as factor in deciding prudence of investment (IRS Notice 2015-62, re **“mission-related investments”**)



# IRC 4944 – Jeopardizing Investments

No investment is per se jeopardizing

“Closely scrutinized” are margin trades, commodity futures, oil/gas working interests, puts/calls/straddles, warrants, short sales

*Regulation examples of jeopardizing investments:*

- Investment in common stock of company with a “promising product” and uneven earnings record that has never paid a dividend and is widely reported in the investment community as seriously undercapitalized may be a jeopardizing investment unless conditional on receiving other capital (Treas. Reg. 53.4944-1(c), Ex. 1)
- Venture capital investment to a new corporation producing a promising product that must compete with an established alternative product serving the same purpose (possibility of substantial long-term appreciation but little prospect of current return) (Treas. Reg. 53.4944-1(c), Ex. 2)

***Focus on process:*** For higher risk investments, document decision to invest in context of Investment Policy Statement and overall portfolio targets, with emphasis on (1) ability to meet short-term charitable needs (5% distribution) and (2) long-term preservation of capital

# IRC 4944 – Program-Related Investments

## Definition of PRI (i.e., venture philanthropy):

- Primary purpose is to accomplish IRC **170(c)(2)(B) purposes**
- Investment would not have been made **but for** relationship between investment and charitable purposes
- **No significant purpose** is production of income or appreciation of property
  - Key factor is whether a private investor would have engaged in the investment on the same terms
- No purpose of the investment is **lobbying** or **political** activity

## 19 examples in the Regulations (Treas. Reg. 53.4944-3(b))

- Ex. 1: Low-interest loan to small business in deteriorated urban area owned by members of economically disadvantaged minority group
- Examples also include equity investments, guarantees, investments in foreign countries, investments with high rate of return, etc.

**Focus on process**, documenting reason for investment

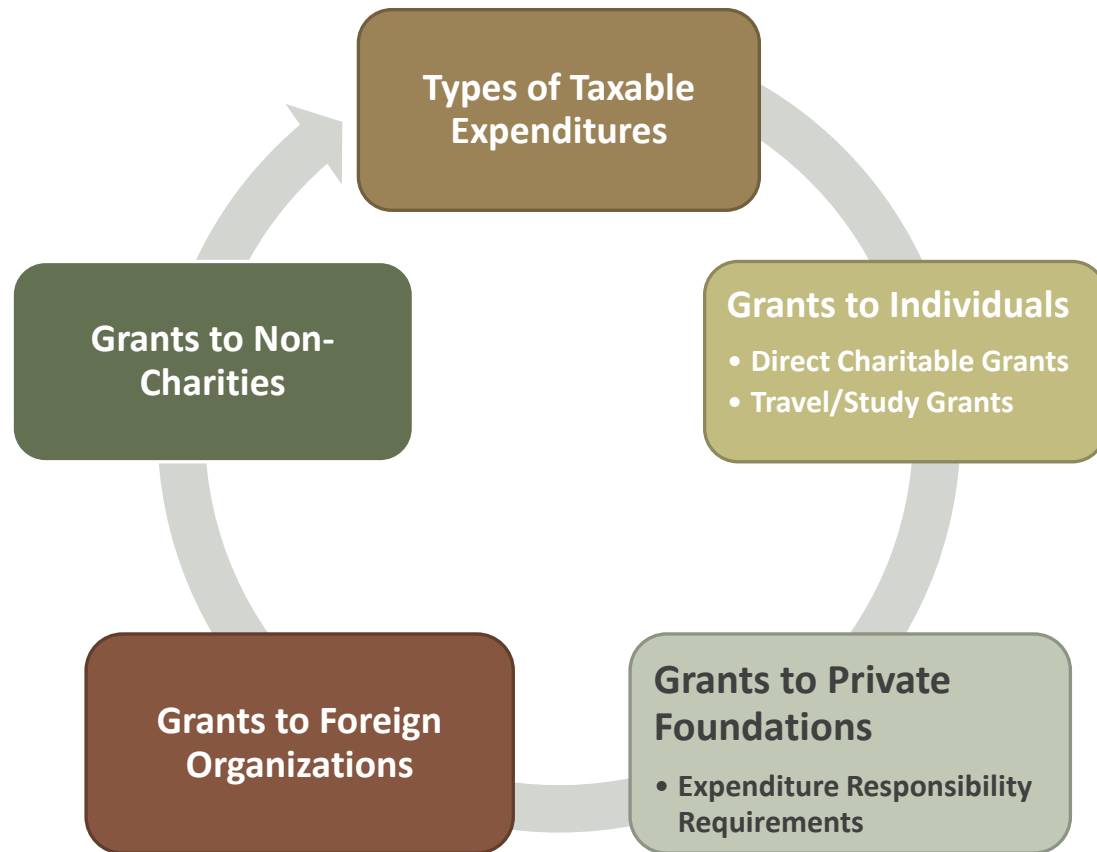
# IRC 4944 – Program-Related Investments

<b>IRC 4941</b>	<ul style="list-style-type: none"><li>• No effect (must still monitor self-dealing)</li></ul>
<b>IRC 4942</b>	<ul style="list-style-type: none"><li>• Counts as exempt-use asset, excluded from denominator for 5% calculation</li><li>• Counts as qualifying distribution</li></ul>
<b>IRC 4943</b>	<ul style="list-style-type: none"><li>• Not excess business holdings (“functionally related business”)</li></ul>
<b>IRC 4944</b>	<ul style="list-style-type: none"><li>• Not jeopardizing investment</li></ul>
<b>IRC 4945</b>	<ul style="list-style-type: none"><li>• Deemed a grant for charitable purposes</li><li>• Must still follow “expenditure responsibility” requirements for PRIs to other than qualifying public charities (see Treas. Reg. 53.4945-5(b)(4))</li></ul>

# IRC 4944 – Investments – Key Takeaways

- ✓ More flexibility with donated assets
- ✓ Prudent investment portfolio in the aggregate likely avoids IRC 4944 concerns (but not necessarily)
- ✓ Focus on process (document reasonable determination as to prudence in entering into risky investments and on mission-related reasons)
- ✓ Consider whether investment qualifies as a PRI

# IRC 4945 – Taxable Expenditures - Overview



# What is a Taxable Expenditure?

**Lobbying or political expenditures**

**Voter registration drives**

**Grants to individuals for travel, study or other similar purposes**

- OK if IRS pre-approval
- Other grants to individuals okay if serving charitable purposes
- Grants to organizations other than public charities
- Grants to private foundations and Type III NFI supporting orgs require expenditure responsibility
- Special rules for grants to foreign organizations (equivalency determination, or expenditure responsibility)

**Expenditures for other than charitable, etc. purposes – even if otherwise in compliance (expenditure responsibility, etc.)**

# How Do I Make Distributions to Individuals?

## Direct charitable distributions

E.g., buying furniture for an indigent individual

## Grants for travel, study or other similar purposes – IRS pre-approval required

- Scholarship programs
- Study abroad
- “Experiential” travel

→ *What about travel to and from a seminar? Travel to give a talk? Travel to provide services?*

# How Do I Make Distributions to Individuals?

## IRS Pre-approval – Use Form 8940 (or Form 1023)

Grant must be awarded on “**objective and nondiscriminatory basis**” (see Treas. Reg. 53.4945-4(b))

- Grantees chosen on basis of criteria reasonably related to purpose of grant
- Pool of candidates must be sufficiently broad (charitable class), unless purpose of grant requires selecting one or a few exceptionally qualified individuals chosen based on ability to fulfil grant purposes
- Independent selection committee (not receiving private benefit based on selection)

Special rules for employer-sponsored scholarship programs

Supervision and record-keeping requirements

**45-Day Rule** (deemed approved by 45th day after submission, unless notified to the contrary) – Treas. Reg. 53.4945-4(d)(3)



# How Do I Make Grants to Private Foundations?

## **Expenditure Responsibility (IRC 4945(h); Treas. Reg. 53.4945-5(b))**

**Pre-grant inquiry** (recipient capable of fulfilling charitable purposes, likely to use funds appropriately, able and willing to keep records and submit reports)

### **Expenditure Responsibility Agreement**

- Very specific requirements as to what this must contain
- Must be in place BEFORE grant is made

### **Annual and Final Reports**

- Must show in detail how funds were used, describe compliance with ER Agreement, and address progress towards achieving charitable purposes
- *Timing Requirement:* Within three months of end of grantee's tax year (April 1, for calendar year filers)

### **IRS Reporting Requirements (via Form 990-PF)**

### **Recordkeeping Requirements**

**Note:** Required for both small and large transactions (certain reorganizations)

# How Do I Make Grants to Foreign Organizations?

**Equivalency Determination** (i.e., “good faith determination” per Treas. Reg. 53.4945-5(a)(5)) - See Rev. Rul. 2017-53

Written advice from a qualified tax practitioner that the grantee is the equivalent of a U.S. public charity

- Exclusively charitable, etc. purposes
- No private inurement
- No political activity; not too much lobbying
- Public support test (valid for two years)
- Commercial Services

## **Expenditure Responsibility**

Either ED or ER will make the grant both (1) count towards the IRC 4942 5% requirement and (2) avoid treatment as an IRC 4945 taxable expenditure

Or use **public charity intermediary** (e.g., “Friends Of” organization)

- Beware “conduit” treatment

# How Do I Make Grants to Non-Charities?

## Possible, but very tricky

Expenditure Responsibility (per Treas. Reg. 53.4945-5) is required, but **not enough**

Must also ensure **exclusively charitable purposes** served per Treas. Reg. 53.4945-6

- Making of grant itself must constitute a direct charitable act or a PRI, OR
- In addition to ER requirements, must require that grantee hold grant funds in a “**separate fund**”, devoted exclusively to charitable purposes

# IRC 4945 – Taxable Expenditures – Key Takeaways

✓ If grantee is not a US public charity, assume ER is required

ER is strictly construed. No “substantial compliance”.

- ✓
  - If to foreign organization, use ER or ED
  - If to non-charity, require “separate fund” (to satisfy both -5 reg’s and -6 reg’s)

Foundations CAN make grants to individuals

- ✓
  - IRS pre-approval only required if for “travel, study or other similar purposes”
  - 45-day rule is helpful, but watch out for later IRS correspondence

✓ If using intermediary (fiscal sponsor, “Friends Of”, etc.) beware conduit treatment

# Excise Tax Chart – PF Chapter 42 Taxes

	Tax on PF	Tax on DP	Tax on Foundation Manager	Abatement Possible?
<b>Self-Dealing (4941)</b>	None	10% First-tier 200% Second-tier	5% First-tier (\$20k cap) 50% Second-tier (\$20k cap) Joint and several	No for DP Yes for FM; “Knowing” violation required for FM First-tier tax; FM Second-tier tax only for FM refusing to agree to correction
<b>Minimum Distribution (4942)</b>	30% First-tier 100% Second-tier	None	None	Yes
<b>Excess Business Holdings (4943)</b>	10% First-tier 200% Second-tier	None	None	Yes
<b>Jeopardizing Investments (4944)</b>	10% First-tier 25% Second-tier	None	10% First-tier (\$10k cap) 5% Second-tier (\$20k cap) Joint and several	Yes for both; FM second-tier tax for FM refusing to agree to correction
<b>Taxable Expenditures (4945)</b>	20% First-tier 100% Second-tier	None	5% First-tier (\$10k cap) 50% Second-tier (\$20k cap) Joint and several	Yes for both; FM second-tier tax for FM refusing to agree to correction

# Correction of Chapter 42 Violations

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**IRC 4941** – Undo the transaction to the extent possible and make the PF whole (fiduciary standard)

**IRC 4942** – Make the required distributions for prior years

**IRC 4943** – Reduce the excess business holdings to permissible levels

**IRC 4944** – Sell or dispose of the jeopardizing investment

**IRC 4945** –

- Recover the expenditure to the extent possible (often not possible)
  - For missing reports, exercise reasonable efforts to procure reports
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## ***Key Principals:***

- Follow regulations carefully and apply fiduciary standards
- Correct transaction before beginning of next tax year
- Correct transaction before filing Form 4720
- Ensure correction doesn't trigger a new Chapter 42 violation (often self-dealing)

# Charitable Vehicles

Private  
Foundations

## Public Charities

- 509(a)(1) / 509(a)(2)
- 509(a)(3) Supporting Organizations

Donor-Advised  
Funds

501(c)(4) Social  
Welfare  
Organizations

“Zuckerberg” LLCs

# Alternatives - Key Goals and Considerations

Control (current and perpetual)

Tax benefits

- Consider gift/estate tax as well as income tax, and be wary of partial interest gifts

Planned activities:

- Operational charitable activities
- Activism (education, issue advocacy, lobbying, political activity)
- International philanthropy
- Support for non-charitable organizations
- Desire to pay compensation to related parties

Privacy



# Private Foundations – Pros and Cons

## PROS

- Control
- Flexible in form and administration
- No need to worry about sources of support

## CONS

- Private foundation rules are limiting
  - Not good if financial transactions with DPs anticipated
  - Not good for accumulation of principal (5% distribution requirement)
  - Not good for gifts of active business interests
  - Extra work for grants to individuals, international grants, grants to non-charities
  - Not good for lobbying activities (in addition to political activities)
- Poor tax benefits
  - Lower AGI limits
  - Limited to cost basis deduction unless cash or qualified appreciated securities

# Public Support Test – 509(a)(1) – 33 1/3% Test

$$\text{Public Support Ratio} = \text{Public Support} \div \text{Total Support}$$

- Calculated over trailing 5-year period
- If qualify, 509(a)(1) for qualifying year and following year
- New organization: Years 1-5 or 2-6

Public Support	Total, Not Public Support	Excluded Entirely
Government grants	Grants above 2% limitation	Unusual grants
Grants from publicly supported organizations*	Unrelated business income	Capital gain income
Part of other grants (up to 2% limitation)	Investment income (other than capital gains)	Program service income**

\* Includes 509(a)(1) public charities that satisfy the public support test under 170(b)(1)(A)(vi) and others (such as churches) that are able to satisfy that test (Treas. Reg. 1.170A-9(f)(6)(i))

\*\* Program service income cannot be substantially all of organization's income for 509(a)(1) (ok for 509(a)(2))

# Public Support Test – 509(a)(1) – Facts & Circumstances

Public Support Ratio between 10% and 33 1/3%

## *Factors*

- Percentage of public support
- Fundraising efforts
- Public visibility
- Broadly representative board

# Public Charities

## PROS

- Better charitable deduction (AGI limits, and fair market value)
- Appropriate for soliciting contributions from others
- Appropriate for more active programming
  - Lobbying activities
  - International grants
  - Grants to individuals and non-charities

## CONS

- More difficult to maintain control (need independent directors, although consider membership structures)
- Must maintain public support test or become private foundation

# Supporting Organizations

**Organizational Test** – May support one or more “specified” supported organizations

**Operational Test** – May provide support to supported organizations or individual members of charitable class supported by them

## **Relationship Test**

- Type I – Parent-subsidiary (power to appoint or elect board majority)
- Type II – Brother-Sister (overlapping boards)
- Type III Functionally Integrated (Substantially all activities directly further supported org’s purposes)
- Type III Non-Functionally Integrated (3.5% distribution requirement, “attentiveness” and “substantial voice” tests, notification requirement)

**Control Test** – Donor and related parties may not control supporting organization

# Supporting Organizations

## PROS

- Private foundation rules do not apply (unless Type III NFI)
- No need to worry about public support test

## CONS

- Can only support limited number of organizations
- Must give up effective control to supported organizations, or meet stringent Type III requirements
- Donors and related parties may not control board (control requirement)

# Donor-Advised Funds – Overview

## What is a DAF? IRC 4966(d)(2)(A)

- A fund at a public charity with special advisory privileges
- “Separately identified” by reference to donor contributions
- Donor or designee has or reasonably expects to have advisory privileges regarding distributions or investments by virtue of his or her status as a donor

## Exceptions IRC 4966(d)(2)(B)

- Single organization DAF
- Certain scholarship funds
- Employer-sponsored disaster relief funds (IRS Notice 2006-109)

# Donor-Advised Funds – Overview

## Consequences of DAF Treatment

- *IRC 4966* - Taxable Expenditure Rules
- *IRC 4967* - Prohibited Benefits
- *IRC 4958(c)(2)* - Automatic excess benefit transactions – grant, loan, compensation or similar payment
- *IRC 4943(e)* - Excess business holdings

## Guidance – Notice 2017-73

- MAY be used to fulfill donor pledges (conditions apply)
- MAY NOT be used to pay for gala tickets
- Considering treating DAF grants as not public support
- Considering not allowing DAF grants to satisfy IRC 4942 distribution requirement for private foundations



# DAFs – Exclusions From Legislative Tax Benefits

## 2020/2021 COVID-relief tax provisions

- 100% AGI limit
- Deduction for non-itemizers

## Disaster-specific tax benefits

- Example, 2018 Bipartisan Budget Act (California Wildfires)

## IRA Rollovers

- Excluded from receiving qualified charitable distributions from IRAs – IRC 408(d)(B)

# DAFs

## PROS

- Public charity tax benefits (AGI limits, fair market value deduction)
- No private foundation rules (though DAF rules may be comparable)
- Little administrative work by DAF donor/advisor

## CONS

- Loss of control over assets (investment and disposition)
- DAF rules may be more restrictive than PF rules (e.g., compensation)
- No distributions to individuals, ever (ensure scholarship funds fit within exception)

# 501(c)(4)s

Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare

- Exclusively public benefit; no private inurement or more than incidental private benefit
- No public support test
- No private foundation rules
- No Form 1023/1024 required
- Lobbying and some political activity okay

Gift tax does not apply, but estate tax does

- IRC 2501(a)(6) – Partial interest rules, etc. don't apply
- Beware IRC 2036

# “Zuckerberg” LLCs

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Anonymity

Coordination of  
philanthropic  
vehicles

Perpetual  
contracting entity

Family succession

Employment of  
G2 and G3

# Comparing Charitable Vehicles

	Pros	Cons
<b>Public Charity</b>	<ul style="list-style-type: none"> <li>- Best tax results for gifts</li> <li>- No private foundation rules</li> </ul>	<ul style="list-style-type: none"> <li>- Loss of control</li> <li>- Public support test</li> </ul>
<b>Donor-Advised Fund</b>	<ul style="list-style-type: none"> <li>- Mostly best tax results for gifts</li> <li>- Fewer administration hassles/risks</li> </ul>	<ul style="list-style-type: none"> <li>- No 100% AGI; no QCDs</li> <li>- Can't give to individuals</li> <li>- Can't freely give to non public charities</li> </ul>
<b>Private Foundation</b>	<ul style="list-style-type: none"> <li>- Control and flexibility</li> </ul>	<ul style="list-style-type: none"> <li>- Restrictive rules</li> <li>- Less favorable tax benefits</li> <li>- Lobbying prohibition</li> </ul>
<b>4947(a)(1) Trust</b>	<ul style="list-style-type: none"> <li>- No need for Form 1023</li> </ul>	<ul style="list-style-type: none"> <li>- Private foundation rules apply</li> <li>- Must file 1041s, pay tax if not all distributed out</li> </ul>
<b>501(c)(4)</b>	<ul style="list-style-type: none"> <li>- No Form 1023/1024 required</li> <li>- No public support test</li> <li>- No private foundation rules</li> <li>- No gift tax</li> </ul>	<ul style="list-style-type: none"> <li>- No income tax deduction</li> <li>- Estate tax concerns if control retained</li> </ul>
<b>LLC</b>	<ul style="list-style-type: none"> <li>- Contracting vehicle for personal / family philanthropy</li> </ul>	<ul style="list-style-type: none"> <li>- It's just an LLC – you haven't done anything tax-wise</li> </ul>



# Hypothetical 1

- Donor has won lottery, wants to devote large portion of winnings to addressing climate change
- Donor is an expert in climate-related matters, and wants to be personally involved in advocacy
  - Support for climate organizations
  - Producing white papers
  - Advocating for changes in policies and laws related to climate change
  - Getting involved in litigation against polluting corporations



## Hypothetical 2

- Family wants to give interest in family business (C Corp) to charity prior to sale of business (no immediate sale prospects)
- Five specific charities they want to benefit
- Close relationship with those charities, many years of gifts, lots of outstanding pledges to each
- Wants to continue to have some control over family business stock until it sells (and perhaps employ family member to oversee investments afterwards)
- Wants to have ongoing influence over use of funds, not just set up restricted funds at charities



## Hypothetical 3

- Donor has PF and DAF
- Family-owned and managed LP invests for family
- LP holds family wealth, set to pass to private foundation on death
- Donor wants to devote some of that wealth now to philanthropy
- Goals:
  - Gift/estate tax (move wealth out of estate)
  - Maintain ability to co-invest in family LP, alongside family vehicles
  - Shield earnings from income tax
  - Not so concerned about tax deduction





## Hypothetical 4

- Donor has PF and DAF
- Wants to devote to charity interest in LLC that holds heavily depreciated and encumbered real estate about to sell. Would like to limit taxes as much as possible.
- Listed, with offers, but no P&S yet
- Wants to use proceeds to fund overall family philanthropy, hiring daughter to serve as “Chief Impact Officer”

# Contact Information

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