FEATURE:
PHILANTHROPY

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Misconceptions Regarding Private Non-Operating Foundations

Practical measures that can help avoid pitfalls

The pandemic has prompted an increased focus on charitable giving. In an effort to encourage donations, recent stimulus legislation made cash gifts to many public charities fully deductible for income tax purposes—but notably excluded contributions to donor-advised funds (DAFs). Notwithstanding this incentive, many large donors will likely continue to provide philanthropic support indirectly through grantmaking (that is, non-operating) private family foundations (PFFs) or DAFs rather than directly to traditional public charities because these vehicles enable donors to obtain an upfront income tax charitable deduction in one year for contributions that may be distributed to charity over a period of years.

Generally speaking, a donor's family can have significantly more control over an independently run PFF than an institutionally administered DAF. But, this greater control comes at the cost of the PFF and its managers being subject to the more burdensome rules and potential excise taxes for certain prohibited activities described in Chapter 42 of the Internal Revenue Code (that is, self-dealing,[1] holding excessively large interests in businesses,[2] investing in a manner that jeopardizes the organization's ability to carry out its charitable purposes,[3] making taxable expenditures[4] and failing to meet minimum charitable distribution requirements[5]) and greater Internal Revenue Service scrutiny.

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Misconceptions regarding PFFs are common, with some people overestimating the magnitude of the challenges posed by these restrictions and others underestimating them. To facilitate informed decision making, let's focus on correcting some key operational, grant-making and investment misconceptions regarding PFFs through a discussion of straightforward, practical measures that a PFF can take to set itself up for success in the face of common pitfalls.

Operational Misconceptions

The word "private" in "private foundation" is in some ways a misnomer. While PFFs have greater control over their activities, investments and operations than public charities (especially DAFs) and are more private in that sense, the steep price of that control can seem overwhelming at first glance. Fortunately, a PFF can take simple steps to minimize the potential for self-dealing and conflicts of interest that pose the greatest operational risk to PFFs.

Adoption of policies and procedures and adherence to formalities. The implementation of internal protocols and a commitment to good recordkeeping and adherence to proper organizational formalities (for example, holding required annual meetings) can mean the difference between success and failure for PFFs. Even though not technically required to obtain tax-exempt status,[6] the best practice for a PFF is to implement policies and procedures for determining and recording decisions about conflicts of interest and compensation, which are the areas that tend to raise the most self-dealing issues.

Conflicts of interest policy and vendor review procedures. Adopting a well-drafted conflicts of interest policy that requires directors and officers to identify and analyze conflicts of interest and following vendor review procedures that are commensurate with risk and

materiality can alert a PFF's officers and directors to—and help to ensure that they seek competent advice regarding—common potential self-dealing transactions that might otherwise go unnoticed, such as renting office space in a building owned by a disqualified person (DP)[7] with respect to the PFF or sharing assets or personnel with another entity owned by one or more DPs.

Compensation and expense reimbursement policies. Similarly, adopting and following a compensation policy that requires consideration of market compensation practices and documentation of the decision-making process and an expense reimbursement policy that requires the submission of receipts and explanatory information, and, in some cases, advance approval, can help to ensure that a PFF doesn't pay excessive compensation to DPs, such as the founder's family members, and that only those expenses that are reasonable and necessary to carry out the PFF's proper purposes are paid by the PFF.[8]

Such policies can also help to highlight instances in which a PFF may be able to re-characterize improper benefits to DPs as reasonable compensation to avoid an act of self-dealing, such as if: (1) the PFF has purchased gala tickets for a director and the director's spouse to attend primarily in a social capacity and not in the course of ordinary and necessary business for the PFF, or (2) the PFF has paid all travel costs for a director to attend a board meeting as part of an extended stay to visit with friends or family.

Grant-making Misconceptions

Although PFFs have significant flexibility in their grant-making activities, adopting and following appropriate governing documents and a grant-making policy, along with engaging an accountant experienced with PFFs, can enable a PFF to define and monitor its mission as part of fulfilling it and avoid common pitfalls. In this context, meeting the minimum distribution requirements while avoiding the prohibitions on taxable expenditures and self-dealing typically pose the greatest challenges.

Instrument of formation. A PFF must be both organized and operated exclusively for one or more purposes specified in IRC Section 501(c)(3) (qualifying purposes), and the PFF's instrument of formation must limit its purposes accordingly.[9] Because a PFF's grants must be made in furtherance of its stated purposes and most donors seek maximum flexibility in this regard, it's typical for a PFF's instrument of formation, which must be filed with the state of incorporation, to track the language of Section 501(c)(3).

A PFF's bylaws will almost always require that the PFF make distributions so as not to subject it to the penalty tax under Section 4942.

Bylaws. A PFF's bylaws are typically easier to amend than its governing instrument, so the governing body of the PFF often determines the specific current goals and values of the PFF and memorializes those in a mission statement included in the bylaws. A PFF's mission statement guides its activities, which include determining to which organizations a PFF can make grants. The mission statement can be limiting both in its purpose (for example, the PFF is founded to help combat homelessness) as well as the types of organizations to which the PFF can make grants (for example, the PFF makes grants to organizations that qualify as exempt organizations under Section 501(c)(3)).

Another factor that can limit potential grant recipients is the requirement under IRC Section 4942 that a PFF make annual "qualifying distributions"[10] in an amount equal to 5% of the fair market value of its net investment assets. Therefore, a PFF's bylaws will almost always require that the PFF make distributions so as not to subject it to the penalty tax under Section 4942. Because not all distributions are qualifying distributions,

in practice many PFFs will only make qualifying distributions to maintain their endowments.

Grant-making policy. A well-drafted grant-making policy can help to ensure that a PFF doesn't make grants for prohibited purposes to prohibited organizations or without following required procedures by reflecting and implementing the following limitations.

Punitive taxes are imposed on a PFF, and in some case its managers, for making certain expenditures classified as "taxable expenditures."[11] In general, taxable expenditures include grants for propaganda, lobbying and other political activities and for purposes other than those described in IRC Section 170(c)(2)(B).

Grants to organizations other than U.S. public charities and private operating foundations, including foreign charities that haven't received a favorable IRS determination of their U.S. tax-exempt status, also constitute taxable expenditures—unless the PFF either: (1) exercises expenditure responsibility[12] as described below, or (2) makes a good faith "equivalency determination" (that is, determines that the foreign organization is equivalent to a U.S. public charity).[13]

Making grants only to U.S. public charities is generally a safe way to avoid making taxable expenditures.

Making grants only to U.S. public charities is generally a safe way to avoid making taxable expenditures and is favored by many PFFs, although others choose to exercise expenditure responsibility to increase their flexibility. Expenditure responsibility encompasses formalized procedures to demonstrate to the IRS that the PFF has taken over responsibility for ensuring that the grant is expended for qualifying purposes.[14] If the PFF will make grants to foreign organizations, it should exercise expenditure responsibility and document its specific procedures to ensure that all donations to the PFF will be entitled to income tax charitable deductions.[15]

In any case, a well-drawn and publicized grant-making policy should cause a family member with a passion for the arts to think about whether a U.S. "friends of" organization exists or an equivalency determination can be made before impulsively donating PFF funds to an iconic Italian church undergoing restoration during a vacation to Italy.

Two common self-dealing transactions that can also be easily avoided by adhering to a well-drafted grant-making policy include: (1) making a grant or other payment that satisfies a pledge or other legal obligation of a DP;[16] and (2) paying for a DP to receive a benefit in exchange for a grant (for example, admission to a gala or dinner).[17]

Holding an annual meeting at which proposed grants are considered and approved in accordance with the PFF's governing documents and grant-making policy is a simple way to help ensure that all required grants—and no impermissible grants—are made.

Investment Misconceptions

For many individuals, investing isn't the first thing that comes to mind when discussing philanthropy. Yet, when developing and monitoring a PFF's investment portfolio, PFF directors and officers must weave carefully through a web of excise taxes, avoiding jeopardizing the PFF's ability to carry out its qualifying purposes, self-dealing and holding excess business interests, all while ensuring that the PFF will be able to satisfy its annual distribution requirement. Unfortunately, these restrictions are also among the least intuitive and most technical of all of the restrictions applicable to PFFs.

For instance, no asset class is a per se prohibited investment for a PFF, although certain assets are subject to additional scrutiny.[18] And, whether an investment is deemed a jeopardy investment turns on the application of the ordinary business care and prudence standard at the time the investment is made and in the context of the PFF's entire portfolio.[19] Additionally, PFFs can't have excess business holdings, which are defined for most purposes as any holdings that exceed a 20% ownership interest in any business enterprise, reduced by the percentage owned by DPs.[20]

Accordingly, although it isn't a legal requirement, the best way for a PFF to promote sound investment decision making and avoid excise taxes is to engage professional investment advisors and adopt an investment policy.

A typical investment policy will include a framework of goals and investment objectives, risk tolerance profile, total return objective and target asset allocation

strategy. It should also include procedures for reviewing and correcting conflicts of interest and excess business holdings and a list of prohibited investments, such as any investment that will cause the PFF to recognize income from debt-financed property that could cause the PFF to become subject to unrelated business income tax (UBIT).[21]

While the IRS has taken the position that it won't issue a ruling on whether a proposed investment procedure will preclude the imposition of the jeopardy investment excise tax,[22] an investment policy can be guided by the IRS' rulings on whether specific transactions would be deemed jeopardy investments,[23] and the PFF's directors and officers can help to protect themselves from personal liability by including a requirement that any investment subject to additional scrutiny can only be made on the advice of legal counsel expressed in a reasoned written legal opinion that the particular investment won't jeopardize the PFF's qualifying purposes.[24]

Many considerations may be taken into account when determining whether a PFF should invest in a certain asset, including the asset's special relationship or special value to the PFF's qualifying purposes,[25] and such a consideration can be reflected in the PFF's investment policy. In addition, a PFF's investment policy can provide separate rules for: (1) donated business interests, which aren't subject to the same divestiture rules for excess business holdings[26] and the jeopardy investment rules,[27] and (2) interests in a business in which at least 95% of the gross income is derived from passive sources, which are excluded from the prohibition against excess business holdings.[28]

Further, because income from debt-financed property that gives rise to UBIT is common with pass-through entities such as private equity and hedge funds organized as partnerships and real estate investment trusts, an investment policy should highlight and prohibit investments in these popular investments unless they're structured to avoid UBIT.

A recurring theme of this article has been the ability of well-drafted formal policies and procedures to both generate awareness of applicable requirements and provide guidelines for acting within them. A typical PFF that adopts and adheres to such policies and procedures should be well-positioned to succeed in its mission, while mitigating its risk of running afoul of IRS restrictions or incurring excise taxes.

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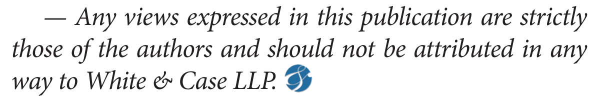

Endnotes

1. Internal Revenue Code Section 4941.
2. IRC Section 4943.
3. IRC Section 4944.
4. IRC Section 4945.
5. IRC Section 4942.
6. *See* instructions for Form 1023.
7. As defined in IRC Section 4946.
8. Compensation payments for personal services rendered aren't considered excessive if they're reasonable under the circumstances, meaning that similarly situated organizations pay similar amounts for similar personal services. Section 4941(d)(2)(E); Treasury Regulations Section 53.4941(d)-3(c)(1), *citing* Treas. Regs. Section 1.162-7.
9. Treas. Regs. Section 1.501(c)(3)-1.
10. The term "qualifying distributions" generally refers to amounts distributed for qualifying purposes and expenses of administering the private family foundation's (PFF) activities in furtherance of its qualifying purposes. IRC Section 4943(g).
11. Section 4945.
12. Section 4945(d)(4)(B).
13. Treas. Regs. Section 53.4945-5(a)(5).
14. Section 4945(h).
15. Revenue Ruling 63-252.
16. Treas. Regs. Section 53.4941(d)-2(f)(1).
17. The charitable contribution that a PFF is permitted to pay would be the amount of the grant in excess of the fair market value of the benefit received in exchange for such grant. Treas. Regs. Section 1.170A-1(h).
18. Treas. Regs. Section 53.4944-1(a)(2)(i).
19. Treas. Regs. Section 53.4944-1(a)(2)(i); note also that program-related investments under Section 4944(c) are an exception to the prohibition against jeopardy investments.
20. IRC Section 4943.
21. IRC Section 511.
22. Rev. Rul. 74-316.
23. *E.g.,* Private Letter Ruling 8125038 (March 24, 1981).
24. Treas. Regs. Section 53.4944-1(b)(2)(v).
25. Notice 2015-62.
26. Sections 4943(c)(6) and (c)(7).
27. Treas. Regs. Section 53.4944-1(a)(2)(ii)(a).
28. Section 4943(d)(3).