CHAPTER ONE

Introduction to Private Foundations

§ 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

There are millions of tax-exempt charitable organizations in the United States, yet only about 90,000 of them are classified, for federal tax purposes, as private foundations. This fact alone—this isolation of foundations purely for purposes of government regulation—makes private foundations unique.

The federal tax law segregates private foundations from other charitable entities, these other entities being generically referred to as *public charities*. Congress differentiated private foundations from other charities in 1969, and in so doing triggered a chain of reactions and developments in the tax law that shows no sign of abating. In a move that made life more complicated for nearly all in the charitable community, the federal tax law presumes that all charitable organizations are private foundations. (The burden of proving non–private foundation status rests with each charitable organization; the process of rebutting the presumption is part of the procedure for filing for recognition of tax-exempt status.[1]) As another example of uniqueness, no other type of tax-exempt organization is accorded such a statutory focus.

Certainly the regulatory regime imposed on private foundations is unique. There is no category of tax-exempt organization that is subject to anything like the compliance burdens that comprise the sweep of Chapter 42 of the Internal Revenue Code. Even the origin of this legislation is unique: The mood of Congress during the course of its endeavors in this regard in the years leading up to the 1969 legislation was very anti–private foundation, with the nation's legislature dismayed at the findings presented to it by the Department of the Treasury in a 1965 report and by a series of congressional hearings.[2] The animosity toward, sometimes hostility against, private foundations that motivated members of Congress and the staff at that time is reflected in the legislation that quickly took shape that year.

When Congress targeted privately funded charities and gave them special status, the following sections were added to the Internal Revenue Code. These sections have operational constraints that govern the conduct of private foundations and impose excise taxes for failures to adhere to the rules.

- IRC § 4940, Tax on Investment Income
- IRC § 4941, Taxes on Self-Dealing
- IRC § 4942, Taxes on Failure to Distribute Income
- IRC § 4943, Taxes on Excess Business Holdings
- IRC § 4944, Taxes on Investments That Jeopardize Charitable Purpose
- IRC § 4945, Taxes on Taxable Expenditures
- IRC § 4946, Disqualified Persons
- IRC § 4947, Application of Taxes to Certain Nonexempt Trusts
- IRC § 4948, Foreign Private Foundations

Sanctions for failure to comply with private foundation rules potentially include a tax (called the *Chapter 42 tax*) on both the foundation and its disqualified persons, loss of tax exemption, and repayment of all tax benefits accrued during the life of the foundation for its funders and itself. Under certain circumstances, these taxes can be abated if the violation was due to reasonable

1. Internal Revenue Code of 1986, as amended, IRC § 508(b). The procedure for filing for recognition of tax-exempt status is the subject of *Tax-Exempt Organizations*, Chapter 25; *Tax Planning and Compliance*, Chapter 18; and *IRS Form 1023 Tax Preparation Guide.*
2. *See* text accompanied by *infra* notes 18 and 20.

cause, rather than for willful and intentional reasons, and if the violation is properly corrected.[3]

Notwithstanding the turbulence within their legal setting, private foundations are a viable and valuable type of nonprofit organization. They are also unique in that they are often used as a means to accomplish the personal philanthropic goals of individuals. Some professional advisors discourage the formation of private foundations because of the complexity of the regulatory rules underlying and surrounding them. There is no question that the foundation rules are often more complicated than those applicable to public charities and other forms of exempt organizations. The reformation of the donor-advised funds and Type III supporting organization rules by the Pension Protection Act of 2006, however, significantly narrowed the differences between those two types of charitable entities and private foundations. Many constraints on operation and procedural requirements formerly only applicable to private foundations now also apply to donor-advised funds and Type III supporting organizations. Exhibit 1.1 displays a comparison of the applicable rules. Persons who decided against creating a private foundation in the past may change their views after studying this chart. Nevertheless, the creation and operation of a private foundation can be a rewarding experience.

Private foundations are ideal charitable vehicles for many funders. An individual can create a foundation qualified for tax exemption and be its sole trustee or director retaining absolute control. Commonly, a donor and his or her family members comprise the governing board of a private foundation, although financial and other transactions between them and the foundation are tightly constrained by the tax law.

Funders who wish to be flexible in their grant-making programs may prefer a private foundation for a similar reason. While a grant payout requirement must be adhered to, there is considerable latitude in the design of its charitable programs. The foundation can maintain its own programs rather than fund others; this entity is the *private operating foundation*. Here a funder can establish the foundation, hire a staff, and work to further his or her own charitable purposes.

Another potential advantage is the fact that family members or other disqualified persons can be paid reasonable compensation in the form of director or trustee fees for their services on the organization's governing board. Disqualified persons can also be paid salaries for services rendered in their capacity as staff members. Those who learn the rules and plan well to adhere to them need not allow the tax law penalties to serve as a deterrent to creation of a private foundation.

Finally, a private foundation can serve as an ideal income and estate planning device for individuals with charitable interests. The classic example

3. IRC § 4962.

Exhibit 1.1

Comparison of Tax Rules Applicable to Private Foundations, Donor-Advised Funds, and Type III Supporting Organizations

	Private Foundation	Donor-Advised Fund	Type III* Supporting Organization
§ 4940 Excise Tax on Investment Income	Yes	No	No
§ 4941 Self-Dealing Prohibitions	Yes	Yes	Yes†
§ 4942 Mandatory Annual Spending	Yes	No	Yes‡
§ 4943 Excess Business Holdings	Yes	Yes	Yes
§ 4944 Jeopardizing Investments	Yes	No	No
§ 4945 Taxable Expenditures	Yes	Yes§	No
Tax Compliance Issues:			
Annual Tax Return	Yes	No	Yes
Anonymity for Donor (Sch. B disclosure)	No	Yes	Yes
Record-Keeping Responsibility	Yes	No	Yes
Tax Deduction 20/30% of AGI	Yes	Higher	Higher
Tax Deduction 30/50% of AGI	Lower	Yes	Yes
Grants to Individuals	Yes	No	Yes
Expenditure Responsibility for Grants to Non-501(c)(3) Organizations	Yes	Yes	No

* Non–functionally integrated. *See* § 15.7.
† IRC §§ 4967 and 4958. *See* § 6.5.
‡ Proposed Reg. § 1.509(a)-4(i)(1). *See* § 15.7(g-1).
§ IRC § 4966. *See* § 16.9.

is a philanthropist who has publicly traded stock that is highly appreciated in value. A private foundation can be created, the securities contributed to the foundation and sold by that entity, and the philanthropist claims a charitable contribution deduction based on the full fair market value of the stock and avoids taxation of the capital gain.[4] The foundation can retain the stock and endeavor to expand its base of principal, and essentially spend only the income from its investments for its charitable purposes.

Philanthropists who make charitable bequests by means of their wills can create private foundations to receive a portion of the bequest while they are

4. *See* § 14.4(b) for possible limitations on the deduction.

living. Contributions to the foundations made during the donor's lifetime are deductible, thereby increasing the estate by reducing income tax. The property gifted to the private foundation and the undistributed income accumulating in the private foundation are not subject to estate tax. A private foundation can also be the remainder interest beneficiary of a charitable remainder trust created during the donor's lifetime. This approach usually results in more after-tax money for the foundation and other beneficiaries.

This unique entity known as a private foundation is thus both heavily regulated by a body of extensive and complex law, and a very useful charitable planning vehicle. To achieve the optimum in charitable giving and granting by means of a private foundation, the management and advisors to the foundation must master this body of law. The pages that follow are intended to be a guide to that end.

Philanthropists seeking to avoid the constraints applicable to private foundations should explore the pros and cons of establishing a supporting organization[5] or a donor-advised fund.[6]

§ 1.2 DEFINITION OF *PRIVATE FOUNDATION*

The federal tax law defines the term *private foundation* as a domestic or foreign charitable organization, other than one of the entities collectively known as *public charities*.[7] Thus, one way to view a private foundation is as a charitable organization[8] that cannot or does not qualify as a form of public charity.

Each U.S. and foreign charitable organization is presumed to be a private foundation; this presumption is rebutted by a showing that the entity is a church, school, hospital, medical research organization, publicly supported charity, supporting organization, or organization that tests for public safety.[9] That is, by operation of law, if a charitable organization cannot be classified as a public charity, it is (or becomes) a private foundation.[10]

Despite the absence of a generic definition of the term, a private foundation essentially is a tax-exempt organization that has these characteristics: (1) it is a charitable organization, (2) it is funded from one source (usually an individual, a family, or a business), (3) its ongoing revenue is derived from investments (in the nature of an endowment fund), and (4) it makes grants to other charitable organizations rather than operate its own program (unless it is a private operating foundation). Congress could have crafted an affirmative definition of the term *private foundation*, using these criteria, but the statutory scheme enacted in 1969

5. *See* § 15.7.
6. *See* Chapter 16.
7. IRC § 509(a). The details of this definition are the subject of Chapter 15.
8. That is, an organization that is tax-exempt pursuant to IRC § 501(a) as an organization described in IRC § 501(c)(3).
9. IRC § 509(a)(1)–(4).
10. IRC § 508(b).

was, as noted, developed in a strenuously anti–private foundation environment and the "definition" was thus devised in a manner to make it as encompassing as possible. (Indeed, the statutory definition is actually one of what a private foundation *is not*, rather than a definition of what a private foundation *is*.)

If circumstances change, or if its creators wish it, a private foundation can terminate its private foundation status. This happens most frequently where the organization's level or mix of funding is such that it can qualify as a publicly supported charity or where the organization converts to a supporting organization. A private foundation can distribute all of its assets to a public charity and dissolve itself or can merge into one or more other private foundations.[11]

§ 1.3 HISTORY AND BACKGROUND

Private foundations have long been much-maligned entities, not only in the federal tax laws but within society at large. Their history, which is extensive, is rich with many successes and strewn with few abuses.[12] They are vehicles for some of the most humanitarian and progressive acts, yet whenever a list of tax reforms is compiled, private foundations, and/or the tax law rules that apply to them, always seem to attract much attention.

A private foundation is a unique breed of tax-exempt organization, in that while it is recognized as charitable, educational, or the like, it is usually controlled and supported by a single source, for example, one donor, a family, or a company. This one characteristic, which the Internal Revenue Service (IRS) has recognized as an indirect but nonetheless qualifying means of support of charity,[13] has spawned several criticisms, including alleged irresponsive governance and inadequate responses to perceived needs. Private foundations are similarly chastised for being elitist, playthings of the wealthy, and havens for "do-gooders" assuaging their inner needs by dispensing beneficence to others.[14]

More serious criticisms of private foundations are that they further various tax inequities, are created for private rather than philanthropic purposes, and do not actually achieve charitable ends.[15] As will be developed in subsequent chapters, nearly all of the abuses—apocryphal or otherwise—involving private foundations were eradicated as the result of enactment of the Tax Reform Act of 1969.[16]

11. *See* Chapter 13.
12. Wormser, *Foundations: Their Power and Influence* (Sevierville, TN: Catholic House Books, 1993); Andrews, *Philanthropic Foundations* (New York: Russell Sage Foundation, 1956).
13. IRS Revenue Ruling (Rev. Rul.) 67-149, 1967-1 C.B. 133.
14. E.g., Branch, "The Case Against Foundations," *Washington Monthly* 3 (July 1971).
15. E.g., Stern, *The Great Treasury Raid* (New York: Random House, 1964), 242–246. *Cf.* Stern, *The Rape of the Taxpayer* (New York: Random House, 1973).
16. As one court stated, Congress enacted these rules "to put an end, as far as it reasonably could, to the abuses and potential abuses associated with private foundations" (*Manheimer Charitable Trust, Hans S. v. Commissioner*, 93 T.C. 35, 39 [1989]).

The origins of private foundations are traceable to the genesis of philanthropy itself. Foundations as legal entities were recognized in the Anglo-Saxon legal system and were fostered in the United States by the law of charitable trusts. Charitable endowments in America are essentially creatures of common law, although amply sustained in statutory laws concerning taxes, corporations, decedents' estates, trusts, and property.[17] The modern American foundation is of relatively recent vintage, dating back to the mid-nineteenth century. Many of the well-known foundations are reflective of the great fortunes established at the advent of the 1900s. Foundations proliferated after World War II, in large part because of favorable economic conditions and tax incentives. More recently, private foundations founded and funded by those successful in the realm of technology are being added to the list of the nation's largest charities.

Foundations were not defined (albeit indirectly) in the Internal Revenue Code (nor in any other federal statute) until 1969—though not because of lack of interest in them by Congress. They were investigated, for example, by the "Walsh Committee" (the Senate Industrial Relations Committee) from 1913 to 1915 for allegedly large stockholdings, by the "Cox Committee" (House Select Committee to Investigate and Study Educational and Philanthropic Foundations) in 1952, by Representative B. Carroll Reece in 1954 (the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations) for alleged support of subversives, and by Representative Wright Patman throughout the 1960s for allegedly tending more to private interests than public benefit. Congressman Patman's inquiries and others' culminated in the extensive foundation provisions of the Tax Reform Act of 1969,[18] which introduced the first statutory definition of the term *private foundation*. Yet a more expressive definition is: ". . . a nongovernmental, nonprofit organization, with funds and program managed by its own trustees or directors, and established to maintain or aid social, educational, charitable, religious, or other activities serving the common welfare."[19]

Controversy persists over the appropriate role for foundations in America—or whether they should exist at all. Foundations are attacked by some as too uninvolved in current issues and problems and by others as too effective in fomenting social change. The federal government is now spending billions of dollars in the realms of health, education, and welfare, formerly the domain of

17. Fremont-Smith, *Foundations and Government, State and Federal Law* (New York: Russell Sage Foundation, 1965), especially Chapter 1.
18. Andrews, *Patman and Foundations: Review and Assessment* (New York: Foundation Center, 1968); Myers, "Foundations and Tax Legislation," *VI Bull. of Found. Lib. Center* (No. 3) 51 (1965). Following a preliminary survey in 1961, Rep. Patman caused publication of "Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy," Chairman's Report to (House) Select Committee on Small Business, First Installment, 87th Cong., 1st Sess. (1962). Six additional installments were published over the period 1963 to 1968.
19. The Foundation Center, *The Foundation Directory*, 4th ed. (1971), vii.

private philanthropy. Recent years have also borne witness to intensified drives for tax reform, tax equality, and tax simplification. These and other developments have made the tax treatment for private foundations and their donors even more vulnerable.

Notwithstanding a variety of anti-foundation developments in the regulatory context, Congress and the executive branch of the federal government have, on occasion, affirmed their support for private foundations. For example, the Department of the Treasury had this to say about the value of foundations:

> Private philanthropy plays a special vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.
>
> Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity.[20]

Private foundations are an integral component of a society that values individual responsibility and private efforts for the public good. One organization championing foundations advances the following rationale:

> Foundations have the particular characteristic of serving as sources of available capital for the private philanthropic service sector of our society in all its range and variety. They thus help make possible many useful public services that would in most cases otherwise have to be provided by tax monies. They offer "the other door on which to knock," without which many volunteer activities would not be initiated and others could not be continued. They are there to respond both to new ideas and [to] shifting social needs with a freedom and flexibility that is not common to or easy for government agencies. Finally, as centers of independent thought and judgment in their own right, they help support freedom of thought, experimentation, and honest criticism directed at pressing needs of the society, including even the scrutiny and evaluation of governmental programs and policies.[21]

The great regulatory surge that swept over private foundations has largely subsided as the regulators have moved on to focus on other types of nonprofit

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20. Treasury Department Report on Private Foundations, Committee on Finance, United States Senate, 89th Cong., 1st Sess. (1965), 5 (also 11–13).
21. Council on Foundations, Report and Recommendations to the Commission on Private Philanthropy and Public Needs on Private Philanthropic Foundations (1974), 1–8.

organizations. The federal tax laws applicable to foundations remain complex, but, for the most part, the foundation community has learned to coexist with them. Nonetheless, it must be conceded that, as the U.S. Tax Court observed (and subsequent chapters indicate), "classification as a private foundation is burdensome."[22]

§ 1.4 PRIVATE FOUNDATION LAW PRIMER

Private foundations are a type of charitable organization, exempt from federal income tax. As such, they are subject to all of the rules applicable to charitable organizations generally. In addition, private foundations are subject to more detailed and stringent rules.

(a) Introduction

The federal tax law pertaining to private foundations was enacted as part of the Tax Reform Act of 1969. The ensuing 40-plus years have not brought much substantive change in the statutory framework. These years, however, have brought many pages of tax regulations, hundreds of private letter rulings, and a considerable number of court opinions.

Private foundation statutory law has inspired similar rules for public charities, most notably the intermediate sanctions rules,[23] some of the supporting organizations rules,[24] and the donor-advised fund rules.[25] Recently, Congress has grafted some of the private foundation rules onto the public charity rules, such as application of the excess business holdings[26] rules to donor-advised funds and application of these rules to supporting organizations.

(b) General Operational Requirements

Private foundations must apply for recognition of tax-exempt status;[27] must file annual information returns with the IRS;[28] must meet a special organizational test;[29] must satisfy certain disclosure requirements;[30] may receive deductible charitable contributions (albeit usually within more stringent limitations than public charities);[31] must adhere to the general rules

22. *Friends of the Society of Servants of God v. Commissioner*, 75 T.C. 209, 212 (1980).
23. IRC § 4958. See *Tax-Exempt Organizations*, Chapter 21.
24. *See* § 15.7.
25. *See* § 16.9.
26. *See* Chapter 7.
27. *See* § 2.5.
28. *See* §§ 12.1, 12.2.
29. *See* § 1.7.
30. *See* § 12.3(b).
31. *See* Chapter 14.

imposed on tax-exempt charities, such as the general organizational test, the operational test, the private inurement doctrine, the private benefit doctrine, the limitation on legislative activities, and the prohibition on political campaign activities;[32] must comply with a battery of unique laws, where the sanctions include imposition of one or more excise taxes (most of which are subject to abatement provisions);[33] must pay an excise tax on net investment income[34] and must comply with the unrelated business rules.[35] Sanctions may apply to disqualified persons.

(c) Disqualified Persons

A variety of persons are considered disqualified persons with respect to a private foundation. These persons are generally equivalent to insiders in connection with the private inurement doctrine.[36]

Disqualified persons with respect to private foundations are (1) substantial contributors, that is, the creator of the foundation if it is a charitable trust or a person that has contributed more than $5,000 to the foundation where the gift amount is in excess of 2 percent of the donee's total support during its existence as measured at the time of the contribution; (2) foundation managers, that is, a foundation trustee, director, officer, or an individual with similar powers or responsibilities; (3) an owner of more than 20 percent of a business where the entity is a substantial contributor; (4) a member of the family of an individual referenced in the foregoing three categories; (5) a corporation, partnership, trust, or estate in which any of the persons referenced in the foregoing four categories have more than a 35 percent ownership or other interest; (6) another private foundation (but only for purposes of the excess business holdings rules); and (7) a government official (but only for purposes of the self-dealing rules).[37]

(d) Self-Dealing Rules

The self-dealing rules essentially prohibit, by means of excise taxes and a correction requirement, financial transactions between a private foundation and a disqualified person.[38]

Generally, self-dealing transactions are (1) sales, exchanges, or leasing of property between a private foundation and a disqualified person; (2) lending

32. *See Tax-Exempt Organizations* §§ 4.3, 4.5, and Chapters 20, 22, and 23, respectively.
33. *See* § 1.10.
34. *See* Chapter 10.
35. *See* Chapter 11.
36. *See Tax-Exempt Organizations* § 20.3.
37. *See* Chapter 4.
38. *See* Chapter 5.

of money or other extension of credit between a private foundation and a disqualified person; (3) furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) payment of compensation, or payment or reimbursement of expenses, by a private foundation to a disqualified person; and (5) payment by a private foundation to a governmental official (with exceptions).[39]

There are exceptions to these general rules, including (1) payment of compensation by a private foundation to a disqualified person for certain personal services, where the compensation is reasonable and is in furtherance of the foundation's exempt purposes; (2) certain lending and furnishing arrangements without interest or other charge, when done in furtherance of charitable purposes; and (3) certain transactions occurring during the administration of a decedent's estate.[40]

These rules are underlain by a series of excise taxes, beginning with an initial tax on an act of self-dealing equal to 10 percent of the amount involved. Another excise tax is imposed on a foundation manager equal to 5 percent of the amount involved, subject to a $20,000 per act maximum tax. An additional tax may be imposed on a self-dealer equal to 200 percent of the amount involved. There is an additional tax on a foundation manager equal to 50 percent of the amount involved, subject to a $20,000 per act maximum tax. The tax liability on foundation managers is joint and several. Tax abatement is not available in this context. A correction requirement is also involved.[41]

(e) Mandatory Payout Rules

The private foundation mandatory payout rules are designed to cause foundations to spend currently rather than indefinitely accumulate income and assets.[42]

A private foundation is generally required to pay out for charitable purposes an amount equal to 5 percent of its noncharitable assets; this involves the concepts of minimum investment return and distributable amount. The amount distributed must be in the form of a qualifying distribution, which can involve a set-aside.[43]

An initial tax is imposed on a private foundation equal to 30 percent of undistributed income. An additional tax may be imposed on a foundation equal to 100 percent of undistributed income. There is a correction requirement. Tax abatement is potentially available.[44]

39. *See* § 5.3.
40. *See* § 5.3(b), (c).
41. *See* § 5.15.
42. *See* Chapter 6.
43. *See* § 6.5.
44. *See* § 6.7.

(f) Excess Business Holdings Rules

The excess business holdings rules are designed to prevent the control of a for-profit business by a private foundation, alone or in conjunction with its disqualified persons.[45]

A private foundation is generally prohibited, by application of excise taxes, from having excess business holdings, which generally means more than a 20 percent interest in a business; where control of the business is elsewhere, the threshold amount is 35 percent. The holdings of disqualified persons are taken into account in calculating these percentages; a 2 percent de minimis rule considers only the foundation's holdings.[46]

An initial tax on a private foundation's excess business holdings is imposed, equal to 10 percent of the value of the holdings. An additional tax may be imposed equal to 200 percent of the value of excess business holdings. There is a correction requirement. Tax abatement is potentially available.[47]

(g) Jeopardizing Investments Rules

The jeopardizing investments rules imposed on private foundations can be viewed as a federal tax law codification of traditional prudent investment principles. These rules parallel state laws under which the managers of a private foundation have a fiduciary responsibility to safeguard its assets on behalf of its charitable constituents.[48]

A private foundation is subject to sanctions if it invests an amount in a manner that would jeopardize the carrying out of an exempt purpose. There is no per se type of jeopardizing investment. An investment jeopardizes exempt purposes of a private foundation where its foundation managers failed to exercise ordinary business care and prudence, at the time the investment was made, in providing for the short-term and long-term financial needs of the foundation in connection with the conduct of its charitable programs.[49]

These rules are inapplicable to program-related investments, the primary purpose of which is to achieve charitable objectives and no significant purpose of which is the production of income or appreciation in the value of property.[50]

An initial tax is imposed on a private foundation in the amount of 10 percent of the jeopardizing investment. An initial tax is imposed on foundation managers in the amount of 10 percent of the investment, when they knowingly participated in it, subject to a $10,000 per investment maximum tax. An

45. *See* Chapter 7.
46. *See* § 7.2.
47. *See* § 7.6.
48. *See* Chapter 8.
49. *See* § 8.1.
50. *See* § 8.3.

additional tax in the amount of 25 percent may be imposed on a private foundation. There is an additional tax on foundation managers, subject to a $20,000 per investment maximum tax. There is a correction requirement. Tax abatement is potentially available.[51]

The Prudent Investor Rules outlined by the American Bar Association in its Restatement of the Law Trust Series contain guidance on this subject.

(h) Taxable Expenditures Rules

The taxable expenditures rules place limitations on the types of grants private foundation are permitted to make.[52]

A private foundation makes a taxable expenditure if it pays or incurs an amount to carry on propaganda or otherwise attempts to influence legislation. These rules may be triggered if a foundation makes a grant to a public charity that attempts to influence legislation or if the foundation makes the expenditure directly. A private foundation may, however, engage in nonpartisan analysis, study, or research, as well as make expenditures that are protected by the self-defense exception.[53]

A private foundation makes a taxable expenditure if it pays or incurs an amount to influence the outcome of a public election, although the funding of certain voter registration drives is permitted.[54] A foundation makes a taxable expenditure if it makes certain types of grants to individuals.[55] A foundation makes a taxable expenditure when it makes a grant, loan, or other form of program-related investment, for charitable purposes, to an entity other than a public charity (except a Type III non–functionally integrated supporting organization), unless it exercises expenditure responsibility.[56] A foundation makes a taxable expenditure if it pays or incurs an amount for a noncharitable purpose.[57] Special rules apply in connection with grants to foreign charities.[58]

An initial excise tax of 20 percent is imposed on a private foundation's taxable expenditure. An initial tax of 5 percent is imposed on a foundation manager who agreed to the making of the expenditure, absent reasonable cause, subject to a per-expenditure maximum tax of $10,000. An additional tax may be imposed on a private foundation at the rate of 100 percent. An additional tax may be imposed on a foundation manager at the rate of 50 percent, subject to a

51. *See* § 8.4.
52. *See* Chapter 9.
53. *See* § 9.1.
54. *See* § 9.2.
55. *See* § 9.3.
56. *See* § 9.9.
57. *See* § 9.8.
58. *See* § 9.5.

per-expenditure maximum tax of $20,000. There is a correction requirement. Tax abatement is potentially available.[59]

(i) Tax on Investment Income

Generally, a private foundation is required to pay an excise tax of 2 percent on its net investment income. Under certain circumstances, this tax is reduced to 1 percent.[60] This tax is not imposed on exempt operating foundations.

(j) Termination of Private Foundation Status

Termination rules apply to private foundations, designed to prevent foundations from ceasing to be a charitable organization so that it can use its funds and assets for noncharitable purposes.[61]

A private foundation's status may be voluntarily terminated by transfer of all of its income and assets to one or more public charities or if the foundation becomes a public charity.[62] A foundation's status may be involuntarily terminated if it engages in willful, flagrant, or repeated acts (or failures to act) giving rise to one or more of the private foundation excise taxes; a foundation in this circumstance would be liable for a termination tax.[63]

Special rules apply when a private foundation transfers assets to another private foundation pursuant to a liquidation, merger, redemption, recapitalization, or other adjustment.[64]

(k) Record-Keeping and Grant-Making Suggestions

A private foundation should maintain a permanent file for each of its grant recipients that reflects the purpose of the grant. The approval process followed, including verification of grantee's qualification either as a public charity or an entity requiring expenditure responsibility agreement, schedule of required follow-up reports, and other information about the grantee would be kept in the file. Some foundations scan and retain all relevant data in an electronic form.

A private foundation should carefully describe its charitable mission and the specific types of programs it supports. Some foundations develop written grant guidelines to inform interested persons of the purposes for which the foundation will grant funds. A grant application or proposal should be required for each potential grantee.

59. *See* § 9.10.
60. *See* Chapter 10.
61. *See* Chapter 13.
62. *See* § 13.1.
63. *See* § 13.2.
64. *See* § 13.5.

From a federal tax law perspective, there is no requirement for a private foundation to keep the paperwork with respect to grants that are not awarded. Some foundations find it useful to retain these materials for a few years for reference in the event an organization replies or there is an inquiry about the grant deliberation process.

(l) Charitable Giving Rules

Generally, contributions to private foundations give rise to a federal income tax charitable contribution deduction.[65]

There are percentage limitations on the deductibility, for federal income tax purposes, of gifts by individuals to charitable organizations. These limitations are more stringent than is the case with respect to gifts to public charities: (1) 30 percent of adjusted gross income in instances of gifts of money (as contrasted with 50 percent for such gifts to public charities) and (2) 20 percent of adjusted gross income in instances of gifts of property (as contrasted with 30 percent for such gifts to public charities). For purposes of these percentage limitations, private operating foundations, private foundations where there are certain distributions out of corpus, and common fund private foundations are treated as public charities.[66]

Generally, a contribution of property that has appreciated in value to a charitable organization gives rise to a charitable deduction based on the property's fair market value. This type of gift to a private foundation, however, generally is deductible only to the extent of the donor's basis in the property, although there is an exception for gifts of qualified appreciated securities.[67]

Gifts to private foundations are subject to the general rules for all charitable gifts as to record-keeping, substantiation, appraisal, disclosure, and reporting requirements.[68] These gifts also qualify for the gift and estate tax charitable deductions.

(m) Unrelated Business Rules

Private foundations are subject to the unrelated business rules.[69] Because of the excess business holdings rules, however, private foundations are limited in their ability to to directly conduct an unrelated trade or business or to invest in pass-through entities that conduct unrelated businesses. The excess business holdings rules exclude from the definition of business enterprise any activity that derives at least 95 percent of its gross income from passive sources, such as

65. *See* Chapter 14.
66. *See* § 14.1(b).
67. *See* § 14.2.
68. *See* § 14.6.
69. *See* Chapter 11.

interest, dividends, royalties, rent, and capital gains. This exclusion ties in with the modifications applicable in the unrelated business context. For these purposes, income does not lose its character as passive income because it is debt-financed. The exceptions to unrelated business income taxation apply with respect to private foundations (although they are infrequently utilized).

§ 1.5 STATISTICAL PROFILE

Private foundations today number, as noted, about 90,000 charitable organizations.[70] These organizations held $588.5 billion in assets for that year.[71] Although more than two thirds of all annual information returns filed by private foundations for 2009 were filed by foundations with less than $1 million in assets, these entities held less than 3 percent of the total assets. The largest foundations, those holding assets valued at $100 million or more, represented less than 1 percent of all returns filed for 2009; these organizations, however, held 58.6 percent of total assets.

Investment assets accounted for almost 92 percent of the total asset value reported by private foundations for 2009. The total amount of investment assets of foundations for that year was $539.8 billion. Revenue of foundations in 2009 totaled $42.4 billion.

Distributions by nonoperating foundations amounted to $43.3 billion. Qualifying distributions, in the form of grants, constituted 88.8 percent of this amount. Another 8.6 percent of qualifying distributions consisted of operating and administrative expenses. Program-related investments, amounts paid to acquire assets, and set-asides accounted for the remaining 2.6 percent of qualifying distributions.

Foundations' qualifying distributions exceeded the required distributable amount of $23.4 billion to varying degrees across each asset-size category. Generally, as asset size increased, the extent to which foundations' qualifying distributions exceeded the required distributable amount decreased. In the aggregate, the small foundations—those with less than $1 million in assets—reported total qualifying distributions that were more than five times larger than their required distributable amount. Foundations with assets between $1 million and $10 million disbursed amounts that were twice their required distributable amount, while those with assets of $10 million or more disbursed slightly less than twice their required distributable amount.

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70. The most recent data concerning private foundations compiled by the IRS is for tax year 2009. In that year, domestic private foundations filed 92,624 annual information returns (Forms 990-PF). The statistics in this section are derived from Belmonte, "Domestic Private Foundations and Related Excise Taxes, Tax Year 2009," 32 *Statistics of Income Bulletin* 114, no. 3 (Winter 2013).
71. This asset value remains significantly below the prerecession amount of $674 billion (for 2007).

Self-dealing acts, of which there were 294, involved $14.9 million; the average act of self-dealing amount was $51,000. Self-dealing taxes totaled $1.7 million, representing the second-largest excise tax amount. The highest amount was for the tax on undistributed income.

Nonoperating private foundations paid $43.3 billion in total qualifying distributions for 2009, of which 88.8 percent were in the form of grants. Program-related investments, amounts paid to acquire assets, and set-asides accounted for 2.6 percent of qualifying distributions. Foundations' qualifying distributions exceeded the required distributable amount of $23.4 billion to varying degrees across the asset-size category; foundations with assets of $10 million or more disbursed slightly less than twice their required amount. A mere 1,285 private foundations reported a total of $20.8 million of taxable undistributed income.

Five private foundations reported nine excess business holdings (totaling $13.7 million); taxes amounted to $1.4 million. Ninety-eight private foundations reported 153 taxable expenditures, causing total tax of slightly more than $640,000. No jeopardizing investments were reported.

§ 1.6 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT

Within the realm of tax-exempt organizations, there are relatively few private foundations; they account for about 5 percent of exempt organizations.

Nearly all tax-exempt organizations are identified as such by federal statute.[72] Some, mostly governmental entities, are exempt in accordance with a constitutional law doctrine, such as the doctrine of intergovernmental immunity.

Of those tax-exempt organizations that have a statutory authorization, more than 50 percent are *charitable* in nature.[73] The term *charitable* encompasses entities that are charitable in a technical sense as well as those that qualify as educational, religious, scientific, and like entities. Each of these types of entities is defined in the federal tax law.[74]

There are, however, many additional types of tax-exempt organizations other than those that are charitable in nature. Other exempt organizations (often ones that private foundations will encounter) include title-holding corporations,[75]

72. Most categories of tax-exempt organizations are the subject of IRC § 501(c). Other types of exempt organizations are referenced in IRC §§ 526–529.
73. That is, they are tax-exempt organizations described in IRC § 501(c)(3).
74. *See* § 1.5.
75. That is, entities described in IRC § 501(c)(2) and (25). *See Tax-Exempt Organizations* § 19.2 and *Tax Planning and Compliance*, Chapter 10.

social welfare organizations,[76] labor organizations,[77] business and professional associations,[78] social clubs,[79] fraternal organizations,[80] veteran's' organizations,[81] and political organizations.[82]

§ 1.7 DEFINITION OF *CHARITY*

A private foundation must be operated for charitable purposes. For the most part, this means that a foundation must confine its grant-making and other programs to charitable ends. One of the many responsibilities, then, of private foundation management is to be certain that each of the foundation's grantees, or its programs, qualify under one or more rationales for being charitable.

The federal tax law definition of the term *charitable* is based on English common law and trust law precepts. Federal income tax regulations recognize this fact by stating that the term is used in its "generally accepted legal sense."[83] At the same time, court decisions continue to expand the concept of *charity* by introducing additional (more contemporary) applications of the term. As one court observed, evolutions in the definition of the word *charitable* are "wrought by changes in moral and ethical precepts generally held, or by changes in relative values assigned to different and sometimes competing and even conflicting interests of society."[84]

The term *charitable* in the federal income tax setting, in the more technical sense, embraces a variety of purposes and activities. These include relief of the poor and distressed or of the underprivileged, the advancement of religion, advancement of education, advancement of science, lessening of the burdens of government, community beautification and maintenance, promotion of health, promotion of social welfare, promotion of environmental conservancy, advancement of patriotism, care of orphans, maintenance of public confidence

76. That is, entities described in IRC § 501(c)(4). *See Tax-Exempt Organizations*, Chapter 13, and *Tax Planning and Compliance*, Chapter 6.
77. That is, entities described in IRC § 501(c)(5). *See Tax-Exempt Organizations* § 16.1 and *Tax Planning and Compliance*, Chapter 7.
78. That is, entities described in IRC § 501(c)(6). *See Tax-Exempt Organizations*, Chapter 14, and *Tax Planning and Compliance*, Chapter 8.
79. That is, entities described in IRC § 501(c)(7). *See Tax-Exempt Organizations*, Chapter 15, and *Tax Planning and Compliance*, Chapter 9.
80. That is, entities described in IRC § 501(c)(8) and (10). *See Tax-Exempt Organizations* § 19.4.
81. That is, organizations described in IRC § 501(c)(19). *See Tax-Exempt Organizations* § 19.11.
82. That is, organizations described in IRC § 527. *See Tax-Exempt Organizations*, Chapter 17, and *Tax Planning and Compliance*, Chapter 23.
83. Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).
84. *Green v. Connelly*, 330 F. Supp. 1150, 1159 (D.D.C. 1971), *aff'd sub nom. Coit v. Green*, 404 U.S. 997 (1971).

in the legal system, facilitating student and cultural exchanges, and promotion and advancement of amateur sports.[85]

Charitable organizations, as that term is used in the most encompassing manner, includes *educational* organizations. In addition to institutions such as schools, colleges, universities, museums, and libraries, educational organizations are those that (1) provide instruction or training of individuals in a variety of subjects for the purpose of improving or developing their capabilities or (2) instruct the public on subjects useful to the individual and beneficial to the community.[86]

Religious organizations are part of the community of charitable organizations. These entities are churches and other membership and nonmembership religious organizations. For reasons of constitutional law, the terms *religion* and *religious* cannot be accorded a definition applied by governmental agencies.[87]

Scientific organizations are, for the most part, those that engage in scientific research. Entities that are scientific in nature may have as their primary purpose the dissemination of scientific information by such means as publications and conferences. These organizations may also be considered educational in nature.[88]

§ 1.8 OPERATING FOR CHARITABLE PURPOSES

A private foundation, as is the case with all tax-exempt charitable organizations, must meet a standard for qualification as a charitable organization, referred to as the *operational test*. This test requires that the private foundation operate *exclusively* to accomplish one or more of the eight purposes referenced in the Internal Revenue Code: religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.[89] The term *exclusively* for purposes of the organizational test does not literally mean exclusively, but rather means *primarily*.[90] Consequently, the conduct of some amount of nonexempt activity is permitted for organizations qualifying for tax exemption as charitable organizations. Due to the application of the private foundation sanctions,[91] however, a private foundation must operate only, or truly exclusively, for one or more of the named charitable

85. Reg. § 1.501(c)(3)-1(d)(2). *See Tax-Exempt Organizations*, Chapter 7, and *Tax Planning and Compliance*, Chapter 4.
86. Reg. § 1.501(c)(3)-1(d)(3). *See Tax-Exempt Organizations*, Chapter 8, and *Tax Planning and Compliance*, Chapter 5.
87. *See Tax-Exempt Organizations*, Chapter 10, and *Tax Planning and Compliance*, Chapter 3.
88. Reg. § 1.501(c)(3)-1(d)(5). *See Tax-Exempt Organizations*, Chapter 9.
89. *See* § 1.5.
90. Reg. § 1.501(c)(3)-1(d)(1)(ii).
91. *See* § 1.10.

purposes. The organizational test also requires that the organization's articles of organization provide that no part of the net earnings of the corporation, community chest, fund, or foundation inure to the benefit of any private shareholder or individual.[92] Simply stated, a private foundation may not operate to accomplish the private purposes or serve the private interests of its founders, those who control it, those who fund it, or their families—these persons are termed *disqualified persons*.[93]

A qualifying private foundation promotes the general welfare of society. Evidence for satisfaction of this operational test is found not only in the nature of the nonprofit's activities but also in its sources of financial support, the constituency for whom it operates, and the nature of its expenditures. The presence of a single nonexempt program, if substantial in nature, will destroy the exemption regardless of the number or importance of the truly exempt purposes.[94]

The benefit to an individual participating in a foundation's programs is acceptable when the activity itself is considered a charitable pursuit. Examples of these benefits are the advancement a student receives from attending college and the relief from suffering experienced by a sick person. The standards of permissible individual benefit are different for certain of the eight categories of charitable purpose, and the distinctions are sometimes vague and not necessarily logical. For example, promoting amateur sports competition is treated as an exempt purpose, but maintaining an athletic facility that restricts its availability to less than the entire community is not charitable.[95] A sports club serving only its individual members is not charitable,[96] but a fitness center promoting health and available to the general public may qualify as a charitable organization.[97] Visiting a museum or attending a play is recognized as educational, but attending a semiprofessional baseball game is not.[98]

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92. *See* § 5.1.
93. *See* Chapter 4. A strange and troublesome opinion from the U.S. Tax Court was based on the operational test. On that occasion, the court held that an organization cannot qualify for tax-exempt status as a charitable or educational entity because its activities and those of its founder, sole director, and officer are essentially identical (*Salvation Navy, Inc. v. Commissioner*, 84 T.C.M. 506 [2002]). The court wrote that the affairs of the organization and this individual are "irretrievably intertwined," so that the "benefits" of tax exemption would "inure" to the individual personally (at 508). Many charities engage in activities that their founders would otherwise personally undertake, and they are under the direct control of these individuals; this is typical of a private foundation.
94. *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 284 (1945).
95. Rev. Rul. 67-325, 1967-2 C.B. 113.
96. *I Media Sports League, Inc. v. Commissioner*, 52 T.C.M. 1092 (1986).
97. E.g., IRS Private Letter Ruling (Priv. Ltr. Rul.) 8935061. An important issue in these private rulings is whether fees charged limit the availability of the facility to the general public—a characteristic required to prove that the organization operates for charitable purposes.
98. *Hutchinson Baseball Enterprises, Inc. v. Commissioner*, 73 T.C. 144 (1979), *aff'd*, 696 F.2d 757 (10th Cir. 1982); *Wayne Baseball, Inc. v. Commissioner*, 78 T.C.M. 437 (1999).

To prove that its programs benefit the public, rather than private individuals, a private foundation often must be found to benefit an indefinite class of persons—a charitable class—rather than a particular individual or a limited group of individuals. It may not be "organized or operated for the benefit of private interests such as designated individuals, the creator's family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests."[99] Thus, a trust established to benefit an impoverished retired minister and his wife cannot qualify.[100] Likewise, a fund established to raise money to finance a medical operation, rebuild a house destroyed by fire, or provide food for a particular person does not benefit a charitable class. An organization formed by merchants to relocate homeless persons from a downtown area was found to serve the merchant class and promote their interests, rather than those of the homeless or the citizens.[101] In explaining the meaning of the word *charitable*, the regulations also deem federal, state, and local governments to be charitable entities by stipulating that relieving their burdens is a form of charitable activity qualifying for tax exemption.[102]

A comparatively small group of individuals can be benefited as long as the group is not limited to identifiable individuals. The class need not be indigent, poor, or distressed.[103] A scholarship fund for a college fraternity that provided school tuition for deserving members was ruled to be a tax-exempt foundation,[104] but a trust formed to aid destitute or disabled members of a particular college class was deemed to benefit a limited class. The "general law of charity recognizes that a narrowly defined class of beneficiaries will not cause a charitable trust to fail unless the trust's purposes are personal, private, or selfish as to lack the element of public usefulness."[105] Criteria for selection of eligible beneficiaries should be followed, and evidence used to choose eligible individuals—case histories, grade reports, financial information, recommendations from specialists, and the like—should be maintained.

A genealogical society tracing the migrations to and within the United States of persons with a common name was found to qualify as a tax-exempt social

99. Reg. § 1.501(c)(3)-1(d)(1)(iii).
100. *Carrie A. Maxwell Trust, Pasadena Methodist Foundation v. Commissioner*, 2 T.C.M. 905 (1943).
101. *Westward Ho v. Commissioner*, 63 T.C.M. 2617 (1992).
102. Reg. § 1.501(c)(3)-1(d)(2); see § 4.6 of *Tax Planning and Compliance* for discussion of standards for qualifying as "Lessening the Burdens of Government." See also "How the Concept of Charity Has Evolved," presentation for the American Bar Association Exempt Organization Committee, 16 *Exempt Org. Tax Rev.* (No. 3) 403–412 (Mar. 1997).
103. *Consumer Credit Counseling Service of Alabama, Inc. v. United States*, 78-2 U.S.T.C. ¶ 9468 (D.C.1979), but *see El Paso del Aquila Elderly v. Commissioner*, 64 T.C.M. 376 (1992) (making burial insurance available at cost for the elderly is a charitable activity only if distress is relieved, by allowing indigents to participate, and the community as a whole benefits).
104. Rev. Rul. 56-403, 1956-2 C.B. 307.
105. IRS General Counsel Memorandum (Gen. Couns. Mem.) 39876.

club, rather than a charity. Although there was educational merit in the historical information compiled, the private interest of the family group was held to predominate.[106] If membership in the society is open to all and its focus is educational—presenting lectures, sponsoring exhibitions, publishing a geographic area's pioneer history—it may be classified as charitable.[107] In contrast, a society limiting its membership to one family and compiling research data for family members individually cannot qualify for tax exemption.[108]

A simple way to prove that an organization operates to benefit a charitable class is for the organization to regrant its monies only to another public charitable organization. Congress imposed such a system on private foundations in 1969 to constrain their grant-making freedom, as described in the analysis of the expenditure responsibility rules.[109] Private foundations can grant monies to individuals and nonpublic entities for a charitable purpose, but only if they enter into a formal contractual agreement with the grant recipient or obtain IRS approval in advance for individual grant programs. Although there are no such formal rules for public charities, a similar burden to prove that grant funds reach a charitable class exists. The IRS inserts the following language in the determination letters of grant-making public charities:

> This determination is based upon evidence that your funds are dedicated to the purposes listed in section 501(c)(3). To assure your continued exemption, you should maintain records to show that funds are expended only for such purposes. If you distribute funds to other organizations, your records should show whether they are exempt under section 501(c)(3). In cases where the recipient organization is not exempt under section 501(c)(3), there should be evidence that the funds will remain dedicated to the required purposes and that they will be used for those purposes by the recipient.

An organization's tax-exempt status was revoked because it failed to prove that its individual refugee relief payments were made to members of a charitable class. The IRS agreed to reinstate the exemption only if all payments were made directly to charitable organizations, governmental units, or organizations that would otherwise qualify as public charities (presumably foreign relief groups such as the World Health Organization or the United Nations Relief Agency).[110] Similarly, an organization lost its exempt status for lack of evidence that it served a charitable class.[111] The organization operated canteen-style lunch trucks and argued that the food was provided to needy persons on a

106. *Callaway Family Association, Inc. v. Commissioner*, 71 T.C. 340 (1978); Rev. Rul. 67-8, 1967-1 C.B. 142.
107. Rev. Rul. 80-301, 1980-2 C.B. 180.
108. Rev. Rul. 80-302, 1980-2 C.B. 182.
109. *See* Chapter 9.
110. Revocation letter dated May 24, 1993, issued to the National Defense Council.
111. *New Faith, Inc. v. Commissioner*, 64 T.C.M. 1050 (1992).

donation or "love offering basis." The evidence found lacking by the court included:

- There was no record of the number of persons, if any, receiving food items for free or below cost nor the number of customers who were impoverished or needy persons.
- No tally of sales below fair market value was maintained.
- Written statements of the organization did not show that food was offered to anybody free or below cost.

The some 9,000 current and former employees, volunteers, and families of an exempt healthcare provider were found by the IRS to be a sufficiently large class of beneficiaries to qualify as a charitable class. Gifts to the assistance fund created by the hospital were ruled deductible as charitable gifts because they were not earmarked for any specific person. The IRS also noted that the contributions were not made with the expectation of individual financial benefit, but instead were voluntary gifts to provide assistance to financially needy persons suffering economic hardship due to accident, loss, or disaster.[112]

The IRS, however, subsequently adopted a contrary position and reversed its ruling that a company foundation's disaster relief program was charitable.[113] Although there was some public benefit from the foundation's provision of assistance in times of disaster or financial crisis, the IRS did not find any assurance that selection of beneficiaries solely among employees of a particular employer serves the best interests of the public. Instead, the foundation was deemed to serve "the private interests of X and its subsidiaries who utilize such benefit programs to recruit and retain a more stable and productive workforce." Because the beneficiaries were a designated or limited group—employees of a specific company—they did not constitute a charitable class, and the foundation could not qualify for a tax exemption. For the same reasons, the disbursements made by the foundation were taxable expenditures[114] of benefit to the company officials and owners. Because the benefit to the company was more than incidental and tenuous, the grants distributed by the foundation also resulted in acts of self-dealing.[115] Additionally, the expenditures did not constitute qualifying distributions[116] because they did not serve a charitable purpose.

112. Priv. Ltr. Rul. 9316051, modified and superseded by Priv. Ltr. Rul. 9741047 (with the IRS stressing the facts that the class of eligible beneficiaries is "sufficiently large and open-ended," and that beneficiaries are selected on an "objective and nondiscriminatory basis" designed to provide relief to those who are "needy and distressed").
113. Priv. Ltr. Rul. 199914040, revoking Priv. Ltr. Rul. 9516047.
114. *See* Chapter 9.
115. *See* § 5.8(c).
116. *See* § 6.5.

A similar issue can arise in connection with a company foundation's scholarship plan. To qualify as a charitable program, this type of plan must meet mathematical tests essentially designed to limit the probability of an employee's qualification to assure that such foundations do not overly serve the private interests of an employer.[117]

§ 1.9 ORGANIZATIONAL RULES

One of the fundamental requirements in the law pertaining to tax-exempt organizations, particularly charitable ones, is that these organizations must be *organized* for one or more tax-exempt purposes. This is known as the *organizational test*.[118]

The organizational test for charitable organizations, in general, emphasizes two requirements. One focuses on the organization's statement of purposes, requiring language that articulates a charitable end and forbidding language that may empower the organization to engage, to more than an insubstantial extent, in noncharitable activities or to pursue noncharitable purposes.[119] The other mandates a *dissolution clause*, which directs the passage of the organization's assets and net income, in the event of its dissolution or liquidation, for charitable ends, usually by causing transfer of the assets and income to one or more other charitable organizations.[120]

There is, however, a separate and additional organizational test for private foundations. A private foundation cannot be exempt from federal income tax (nor will contributions to it be deductible as charitable gifts) unless its governing instrument or the provisions of state law applicable to it include provisions, the effects of which are to require distributions at such time and in such manner as to comply with the annual payout rules and prohibit the foundation from engaging in any act of self-dealing, retaining any excess business holdings, making any jeopardizing investments, or making any taxable expenditures.[121] Generally, these provisions must be in the foundation's articles of organization[122] and not merely in its bylaws.[123]

The provisions of the governing instrument of a private foundation or applicable state law must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation

117. *See* § 9.3(e).
118. Reg. § 1.501(c)(3)-1(b).
119. Reg. § 1.501(c)(3)-1(b)(1).
120. Reg. § 1.501(c)(3)-1(b)(2).
121. IRC § 508(e)(1); Reg. § 1.508-3(a). *See* Chapters 5–9.
122. *See* § 2.1.
123. Reg. § 1.508-3(c).

managers or other disqualified persons with respect to the foundation, will not be liable for any of the private foundation excise taxes.[124] The governing instrument of a nonexempt split-interest trust[125] must contain comparable provisions in respect to any of the applicable private foundation excise taxes.[126]

Specific reference in the governing instrument to the appropriate sections of the Internal Revenue Code is generally required, unless equivalent language is used that is deemed by the IRS to have the same full force and effect. A governing instrument that contains only language sufficient to satisfy the requirements of the organizational test for charitable organizations in general, however,[127] does not meet the specific requirements applicable with respect to private foundations, regardless of the interpretation placed on the language as a matter of law by a state court.[128] A governing instrument of a private foundation does not meet these organizational requirements if it expressly prohibits the distribution of capital or corpus.[129]

A private foundation's governing instrument is deemed to conform with the requisite organizational requirements if valid provisions of state law have been enacted that require the foundation to act or refrain from acting so as not to subject it to any of the private foundation excise taxes or that treat the required provisions as being contained in the foundation's governing instrument.[130] The IRS ruled as to which state statutes contain sufficient provisions in this regard.[131]

Any provision of state law is presumed to be valid as enacted and, in the absence of state law provisions to the contrary, applies with respect to any private foundation that does not specifically disclaim coverage under state law (either by notification to the appropriate state official or by commencement of judicial proceedings).[132] If a state law provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the state involved or by the U.S. Supreme Court, the foundations covered by the determination must meet the private foundation organizational

124. Reg. § 1.508-3(b)(1). Rev. Rul. 70-270, 1970-1 C.B. 135, contains sample governing instrument provisions.
125. *See* § 13.2.
126. Reg. § 1.508-3(b)(1). Rev. Rul. 74-368, 1974-2 C.B. 390, contains sample governing instrument provisions.
127. *See* text accompanied by *supra* note 116.
128. Reg. § 1.508-3(b)(1).
129. Reg. § 1.508-3(b). In one instance, a charitable testamentary trust was found to have violated the private foundation organizational rules because the trust instrument required the trust to accumulate, rather than distribute, income; a state court ordered modification of the instrument to provide for the requisite distribution of the foundation's income (*Estate of Lee H. Barnes*, 74-1 U.S.T.C. ¶ 9241 [Court of Common Pleas of Lancaster County, Pa. (1973)]).
130. Reg. § 1.508-3(d)(1).
131. Rev. Rul. 75-38, 1975-1 C.B. 161.
132. Reg. § 1.508-3(d)(2)(i).

requirements within one year from the date on which the time for perfecting an application for review by the Supreme Court expires. If this application is filed, these requirements must be met within one year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision on the merits.[133] If a provision of state law is declared invalid or inapplicable with respect to a class of foundations by a court of competent jurisdiction, and the decision is not reviewed by the highest state appellate court or the Supreme Court, and the IRS notifies the general public that the provision has been declared invalid or inapplicable, then all private foundations in the state involved must meet these organizational requirements, without reliance on the statute to the extent declared invalid or inapplicable by the decision, within one year from the date the notice is made public.[134] These rules do not apply to a foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to the foundation.[135]

In one case, a charitable trust created by will in 1967 had its trust instrument amended by court order to enable the trust, a private foundation, to comply with the organizational requirements.[136] In a similar case, the trustees of a private foundation were permitted by a state court to modify a trust document to facilitate compliance by the foundation with these organizational rules.[137]

§ 1.10 PRIVATE FOUNDATION SANCTIONS

The federal tax rules pertaining to private foundations are often stated as if they are laws, in the sense of rules governing human conduct. This is technically not the case, in that these rules—comprising part of the Internal Revenue Code—are cast as tax provisions. Thus, the law states that if a course of conduct is engaged in, the imposition of one or more taxes will be the (or a) result. For example, there is no rule of law that states that a private foundation may not engage in an act of self-dealing; rather, the law is that an act of self-dealing will trigger a tax.

Each of the private foundation rules, then, is underlain with a series of taxes. These are portrayed as excise taxes. The taxes are severe and are intended to deter or stimulate conduct, rather than to raise revenue.

133. Reg. § 1.508-3(d)(2)(ii).
134. Reg. § 1.508-3(d)(2)(iii).
135. Reg. § 1.508-3(d)(2)(iv).
136. *Matter of Jeanne E. Barkey*, 71-1 U.S.T.C. ¶ 9350 (Surrogate's Court of New York County, NY [1971]).
137. *William Wikoff Smith Trust Estate, "The W. W. Smith Foundation,"* 72-1 U.S.T.C. ¶ 9271 (C.P. Montgomery County Orphans' Court, Pa. [1971]).

Indeed, these excise taxes are more accurately characterized as penalties. For example, the legislative history of the self-dealing rules is replete with references to the tax sanctions as "penalties." The report of the House Committee on Ways and Means accompanying its version of the 1969 tax legislation stated that the "permissible activities of private foundations . . . are substantially tightened to *prevent* self-dealing between the foundations and their substantial contributors."[138] The Committee added that it "has determined to generally *prohibit* self-dealing transactions and provide a variety and graduation of sanctions."[139] In this report there are numerous references to these sanctions as constituting "prohibitions" or arising out of "prohibited" conduct. Identical or similar language appears in the report of the Senate Committee on Finance in its version of the 1969 legislation.[140] This continues to be the view of Congress on the subject, in that a report of the Ways and Means Committee issued in 1996 refers to the private foundation rules as a "penalty regime."[141]

The courts, as well, view these private foundation tax provisions as penalties. For example, two federal appellate courts rejected the argument that the self-dealing taxes are mere excise levies and held that these taxes are penal in nature.[142] This wide-ranging view that the private foundation rules are sanctioned by penalties inevitably leads to the view that the rules broadly encompass foundations' operations. Certainly the IRS accords the broadest of interpretations to this area of the law and, correspondingly, strict and narrow readings as to the exceptions.

Because of the nature of this statutory tax structure, a person subject to tax does not merely pay it and continue with the transaction and its consequences, as is the case with nearly all other federal tax regimes. This structure weaves a series of spiraling taxes from which the private foundation, and/or disqualified person(s), can emerge only by paying one or more taxes and either correcting (undoing) the transaction involved by repaying the money or returning assets or having the foundation's income and assets confiscated by the IRS.

The private foundation rules collectively stand as devices Congress created for the purpose of curbing what was perceived as a host of abuses being perpetrated through the use of private foundations by those who control or

138. H. Rep. No. 91-413, 91st Cong., 1st Sess. (1969), Part I at 4 (emphasis added).

139. *Id.*, Part IV at 21 (emphasis added).

140. S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969).

141. H. Rep. No. 104-506, 104th Cong., 2d Sess. 56 (1996). This observation was made in the context of a discussion of the intermediate sanctions rules applicable with respect to public charities, social welfare organizations, and certain nonprofit insurance issuers (IRC § 4958), which in many ways are structured in the same fashion as the private foundations rules. In general, *see Intermediate Sanctions*.

142. *Mahon v. United States* (In re Unified Control Systems, Inc.), 586 F.2d 1036 (5th Cir. 1978); *United States v. Feinblatt* (In re Kline), 547 F.2d 823 (4th Cir. 1977). Also *Rockefeller v. United States*, 572 F. Supp. 9 (E.D. Ark. 1982), *aff'd per curiam*, 718 F.2d 290 (8th Cir. 1983), *cert. den.*, 460 U.S. 962 (1984); *Estate of Bernard J. Reis v. Commissoner*, 87 T.C. 1016 (1986).

manipulate them (disqualified persons).[143] Congress addressed the problems from several directions, through prohibitions on self-dealing,[144] mandatory payouts for charitable purposes,[145] prohibitions on substantial holdings of business enterprises,[146] prohibitions on engaging in jeopardizing (speculative) investments,[147] and a cluster of other banned activities, the funding of which is considered taxable expenditures.[148] These and other related provisions comprise Chapter 42 of the Internal Revenue Code. Similar constraints were placed on certain supporting organizations and donor-advised funds in 2006.[149]

The taxes imposed for violation of the private foundation rules are structured as a tripartite level of taxation: initial (first-tier) taxes, additional (second-tier) taxes, and the involuntary termination (third-tier or confiscation) taxes. The first and second of these taxes are characterized as excise taxes and are outlined in Exhibit 1.2.[150] The third of these taxes is imposed when the IRS requires termination of the foundation due to flagrant violations of the rules.[151] Form 4720 is filed to report the incidents and calculate any taxes due.[152]

The penalty provisions of these excise taxes do not contain an exception, or excuse, for imposition of the penalty on a private foundation for failure to comply with the specific provisions. The regulations accompanying these provisions, however, contain relief for those foundation managers who do not condone or participate in the decision to conduct a prohibited action. Until 1984, the penalties were strictly applied.[153] Congress in 1984 added statutes[154] to permit abatement of the penalties imposed on both the foundation and its managers if it is established to the satisfaction of the IRS that:

- The taxable event was due to reasonable cause and not to willful neglect, and
- The event was corrected within the correction period for such event.

143. *See* Chapter 4.
144. *See* Chapter 5.
145. *See* Chapter 6.
146. *See* Chapter 7.
147. *See* Chapter 8.
148. *See* Chapter 9.
149. *See* Chapters 15 and 16.
150. The specifics of these excise taxes for each of the sets of private foundation rules are the subject of the last sections of Chapters 5–9.
151. *See* Chapter 13.
152. This form is reproduced as Exhibit 12.6 in Chapter 12.
153. *Charles Stewart Mott Foundation v. United States*, 91-2 U.S.T.C. ¶ 50340 (6th Cir. 1991); *Mannheimer Charitable Trust, Hans S. v. Commissioner*, 93 T.C. 35 (1989).
154. IRC §§ 4961– 4963.

Exhibit 1.2

Private Foundation Excise Taxes

	Tax Imposed On		Initial Tax		Additional Tax	
Sanction	Private Foundation	Managers	First-Tier Rate	Imposed	Second-Tier Rate	Assessed
Section 4940 Investment Income Tax	X		2%	Of investment income imposed annually when Form 990-PF filed.	N/A	Not applicable.
	X		1%	Tax reduced by 1 percent for PFs increasing grants annually.		
Section 4941 Self-Dealing		On self-dealer X	10%	Of amount involved for each year transaction outstanding.	200%	If self-dealing not corrected.
		On manager X	5%	Of amount involved for each year transaction outstanding. Participating managers jointly and severally liable; can agree to allocate among themselves; maximum for managers $10,000.	50%	If manager refuses to agree to part or all of correction. Maximum additional tax $10,000.
Section 4942 Undistributed Income	X		30%	Of undistributed income for each year undistributed.	100%	For each year income remains undistributed.
Section 4943 Excess Business Holdings	X		10%	On fair market value of excess holdings each year.	200%	Of excess holdings at end of "taxable period."

(Continued)

EXHIBIT 1.2 (Continued)

Sanction	Tax Imposed On: Private Foundation	Tax Imposed On: Managers	Initial Tax: First-Tier Rate	Initial Tax: Imposed	Additional Tax: Second-Tier Rate	Additional Tax: Assessed
Section 4944 Jeopardizing Investments	X		10%	On amount so invested for each year of taxable period.	25%	Of amount not removed from jeopardy.
		X	10%	On amount so invested for each year of investment. Participating managers jointly and severally liable for maximum tax of $5,000 per investment.	5%	Of amount on managers who refused to agree to part or all of removal from jeopardy; maximum for management $10,000.
Section 4945 Taxable Expenditures	X		20%	Of each taxable expenditure.	100%	Of uncorrected expenditure at end of taxable period.
		X	5%	Of each taxable expenditure for manager who knew of and agreed to the expenditure. Maximum for all managers $5,000.	50%	Of amount on manager who refuses to correct all or part of taxable amount; maximum amount $10,000.

To allow abatement, the actions of the responsible foundation officials must be considered. Although one of these provisions[155] is titled "Definitions," neither it nor the regulations define the terms *reasonable cause* or *willful neglect*. There have not been any court decisions and few IRS private determinations[156] concerning abatement of these penalties. In a ruling concerning a taxable expenditure penalty for failure to seek advance approval of a scholarship plan, there was no mention of abatement.[157]

The regulations pertaining to the penalties imposed on self-dealers, on managers approving of self-dealing, jeopardizing investments, and taxable expenditures, however, contain definitions that one must hope can be applied to justify abatement of the penalties. The definitions of *reasonable cause* and *willful* are the same as those listed above. The officials of private foundations must show that they used good business judgment exercised with ordinary business care and prudence. They must show that they made a good faith effort to follow the rules by seeking the advice of qualified professionals. All of the facts and circumstances of the foundation's activities must be fully disclosed to such advisors.

For the foundation's penalty to be abated, its managers must also prove that the failure was due to reasonable cause and not to willful neglect. A bankruptcy judge found that a trustee had not demonstrated conscious, intentional, or reckless indifference in failing to file a return or obtain an extension, so reasonable cause for abating penalties existed.[158]

Under the general rules pertaining to tax penalties,[159] the determination of whether a taxpayer's actions were due to reasonable cause in good faith is made on a case-by-case basis. According these rules, "generally, the most important factor is the extent of the taxpayer's effort to access the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." This regulation provides that reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. This type of reliance, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. Reliance on the opinion or advice of a professional is considered reasonable cause if:

155. IRC § 4962.
156. Tech. Adv. Mem. 9424004. *See* Chapter 7, note 133.
157. Priv. Ltr. Rul. 9825004.
158. *United States Bankruptcy Court of Central District of California re Molnick's, Inc.*, 95-1 U.S.T.C.¶ 95,751 (9th Cir. 1995).
159. Reg. § 1.6664-4(b); *see* also §§ 8.4 and 9.8.

- The taxpayer did not know, or should not have known, that the advisor lacked knowledge in the relevant aspects of federal tax law.
- The advice was based on all pertinent facts and circumstances and the tax law as it relates to the matter involved, including the taxpayer's purpose for entering into the transaction and for structuring a transaction in a particular manner.
- The advice is based on reasonable factual or legal assumptions and does not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person.

The second-tier taxes may also be abated.[160]

When enacted in 1969, the private foundation rules were unique. The statutory scheme devised by Congress had no precedent in the tax law. (The only other prior occasion when Congress levied a tax on otherwise tax-exempt organizations was on adoption of the tax on unrelated business income, implemented in 1950.)[161] But in the immediate aftermath of enactment of the foundation rules, speculation started as to whether and to what extent this new approach might be extended to other tax-exempt organizations, principally public charities. Since then, the rules engendered to reform the conduct of private foundations have been replicated in varying degrees by Congress four times, principally with respect to the operations of public charities: taxes on lobbying expenditures,[162] taxes on political campaign expenditures,[163] and taxes on the rendering of excess benefits to disqualified persons.[164] Thus, private foundations law set in motion the use of a tax scheme that has been utilized since and undoubtedly will be used again. But the amount of interpretative law built up around these statutory rules is most extensive in respect to private foundations.

160. IRC § 4961. A private foundation that failed to make any grants for charitable purposes during its existence, to pay any tax on its net investment income, to pay penalties for late filing of its annual information returns, and to respond to inquiries from the IRS and state officials had its tax exemption revoked (Priv. Ltr. Rul. 201021029).
161. *See* Chapter 11.
162. IRC §§ 4911 and 4912.
163. IRC § 4955.
164. IRC § 4958.