CHAPTER 1

Basic Legal Definitions

One of the most complex bodies of statutory law in the tax-exempt organizations setting is the battery of rules applicable to private foundations. Created over 30 years ago, the private foundation rules are the subject of hundreds of private determinations by the Internal Revenue Service (IRS) (and a few court opinions), and this process continues unabated. New issues constantly arise. This body of law can be onerous and, because of a myriad of penalty excise taxes, can be costly.

If a charitable organization can avoid being a private foundation, it is well advised to do so. If, however, private foundation status is unavoidable, the rules governing private foundations must be faced. Life as a private foundation is by no means impossible, but the organization's management and its advisors should proceed with caution.

Here are the questions most frequently asked (or those that should be asked) about the basic legal definitions in the private foundation rules—and the answers to them.

Q 1:1 What is a *private foundation*?

There is no affirmative definition of the term *private foundation.* The statutory definition basically states that a private foundation is a charitable organization[1] that is not a public charity (Q 1:2).

Generically, a private foundation has four characteristics:

1. It is a charitable organization.[2]
2. It is initially funded from one source (usually an individual, a married couple, a family, or a business).
3. Its ongoing income derives from investments (in the nature of an endowment fund).

4. It makes grants to other charitable organizations rather than operate its own program.

The nature of its funding and, sometimes, the nature of its governance (i.e., a closed, family-oriented board of trustees) are the characteristics that make this type of charitable organization *private.* This entity is sometimes referred to as the *standard* private foundation (Q 1:34).

NOTE: The Internal Revenue Code is misleading in this regard. The pertinent Code section is styled "Private foundation defined."[3] But, in fact, that section does not define the phrase *private foundation* at all. Rather, it defines what a private foundation *is not,* by listing the types of charitable organizations that are not private foundations.

Also, although technically this is not part of a *definition* of the term *private foundation,* there are some organizations that, for one or more purposes, are *treated as* private foundations, such as charitable remainder trusts (Q 17:28).

Q 1:2 What is a *public charity*?

There are several types of public charities (Chapter 12). One category includes churches, integrated auxiliaries of churches, associations and conventions of churches, universities, colleges, schools, hospitals, medical research organizations, and certain governmental entities. These are sometimes referred to as the *institutions* (Q 12:2).

Another category of public charity is the publicly supported charity. There are two basic types of publicly supported charity: the *donative* type (principally supported by gifts and grants) (Q 12:4) and the *service provider* type (principally supported by exempt function revenue, gifts, and/or grants) (Q 12:8).

The third category of public charity is the *supporting organization* (Q 12:15).

In applying these definitions of the term *public charity,* and in deciphering the private foundation rules, it is often critical that the charitable organization know which persons are disqualified persons (Q 1:3) with respect to it.

Q 1:3 What is a *disqualified person*?

A basic concept of the tax laws relating to private foundations is that of the *disqualified person* (Chapter 2). Essentially, a disqualified person is a person (including an individual, corporation, partnership, trust, or estate) that has a particular, usually intimate, relationship with respect to a private foundation.[4]

Thus, disqualified persons are commonly trustees, directors, officers, substantial contributors, members of their families, and controlling and controlled entities. The first three of these persons are collectively known as

foundation managers. A controlling person is a *20 percent owner,* and controlled entities are corporations, partnerships, trusts, and estates.

In the public charity context, this definition generally is inapplicable. (It is used, however, in connection with the computation of public support in the case of service provider publicly supported entities (Q 12:8).) The term *disqualified person,* however, is used as part of the intermediate sanctions rules.[5] In that context, the term is broader in scope than that in the private foundation setting, in that the concept of *member of the family* there includes siblings (Q 2:15).

Also, in the public charity context, the *private inurement* doctrine applies.[6] There, the equivalent to the disqualified person is the *insider.* There is considerable controversy as to the sweep of this term. Clearly, the idea of the *insider* embraces trustees, directors, officers, and key employees. The controversy, however, is whether and to what extent it extends to vendors of goods and services, such as fund-raising companies.[7]

Q 1:4 Just what are the *private foundation rules*?

The federal tax law governing the operations of private foundations is a composite of rules pertaining to self-dealing (Chapter 3), mandatory payout requirements (Chapter 4), business holdings (Chapter 5), investment practices (Chapter 6), various types of expenditures (Chapter 7), and more.

Q 1:5 What are the sanctions for violation of these rules?

The sanctions for violation of these rules are five sets of excise taxes, with each set entailing three tiers of taxation. The three tiers are known as the *initial tax,*[8] the *additional tax,*[9] and the *involuntary termination tax.*[10]

In general, when there is a violation, the initial tax must be paid; the additional tax is levied only when the initial tax is not timely paid and the matter not timely corrected (Q 1:10). The termination tax (Chapter 13)—a third tax—is levied when the other two taxes have been imposed and there continues to be willful, flagrant, or repeated acts or failures to act giving rise to one or more of the initial or additional taxes.

Because of the stringency of these rules, the sanctions are far more than merely taxes; rather they are a system of absolute prohibitions.

Q 1:6 What are the rules concerning *self-dealing*?

In general, the federal tax law prohibits acts of self-dealing between a private foundation and a disqualified person (Chapter 3).[11] An act of self-dealing may be *direct* or *indirect.* The latter generally is a self-dealing transaction between a disqualified person and an organization controlled by a private foundation.[12]

The sale or exchange of property between a private foundation and a disqualified person generally constitutes an act of self-dealing.[13] The transfer of real or personal property by a disqualified person to a private foundation is treated as a sale or exchange if the property is subject to a mortgage or similar

lien that the foundation assumes, or if it is subject to a mortgage or similar lien that a disqualified person placed on the property within the 10-year period ending on the date of transfer.[14]

The following generally constitute acts of self-dealing:

- The leasing of property between a private foundation and a disqualified person.[15]
- The lending of money or other extension of credit between a private foundation and a disqualified person.[16]
- The furnishing of goods, services, or facilities between a private foundation and a disqualified person.[17]
- The payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person.[18]

The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation generally constitutes self-dealing.[19] Unlike the other sets of rules describing specific categories of acts of self-dealing, this one is a catch-all provision designed to sweep into the ambit of self-dealing a variety of transactions that might otherwise technically escape the discrete transactions defined to be those of self-dealing. Benefits to a disqualified person can occur when the foundation's assets are used by one or more parties that are not disqualified persons. There is no requirement that a disqualified person is intended to be benefited.

This is one of the most dangerous aspects of the self-dealing rules, in that self-dealing can occur without the parties realizing it. Part of the problem is that the *benefit* involved can be intangible, such as increased goodwill,[20] enhanced reputation,[21] and the provision of marketing advantages[22]—all with respect to nondisqualified persons.

TIP: This phraseology is also in the definition of the term *excess benefit transaction.*[23] As is the case with respect to much of the law defining self-dealing, developments in the private foundation arena can be used to interpret the intermediate sanctions rules. The reverse also is true.

An agreement by a private foundation to make a payment of money or other property to a government official generally constitutes self-dealing, unless the agreement is to employ the individual for a period after termination of his or her government service if the individual is terminating service within a 90-day period.[24]

Q 1:7 Are there any exceptions to the self-dealing rules?

There are many exceptions to the self-dealing rules. For example, in relation to the general prohibition on leasing transactions (Q 1:6), the leasing of property by a disqualified person to a private foundation without charge is not an

act of self-dealing.[25] Likewise, in respect to the general prohibition on extensions of credit (Q 1:6), this rule does not apply to an extension of credit by a disqualified person to a private foundation if the transaction is without interest or other charge and the proceeds of the loan are used exclusively for charitable purposes.[26]

Concerning the general ban on furnishing of goods, services, or facilities (Q 1:6), the furnishing of goods, services, or facilities by a disqualified person to a private foundation is not an act of self-dealing if they are furnished without charge and used exclusively for charitable purposes.[27] Moreover, the furnishing of goods, services, or facilities by a private foundation to a disqualified person is not self-dealing if the furnishing is made on a basis no more favorable than that on which the goods, services, or facilities are made available to the general public.[28]

As to the rules in respect to compensation (Q 1:6), except in the case of a governmental official, the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person for the performance of personal services that are reasonable and necessary to carrying out the charitable purpose of the foundation is not self-dealing if the compensation (or payment or reimbursement) is not excessive.[29]

CAUTION: This exception is not necessarily as attractive as it might initially appear. A court held that the term *personal services* is confined to services that are "essentially professional and managerial" in nature.[30] In that case, the services involved were found not to qualify for the exception, being general maintenance, janitorial, and custodial services.

As to the catch-all provision (Q 1:6), the fact that a disqualified person receives an incidental or tenuous benefit from a private foundation's use of its income or assets will not, by itself, make the use an act of self-dealing.[31] In the case of a government official, the self-dealing rules do not apply to the receipt of certain prizes and awards, scholarship and fellowship grants, annuities, gifts, and traveling expenses.[32]

By reason of another exception, a transaction between a private foundation and a corporation that is a disqualified person with respect to the foundation is not an act of self-dealing if the transaction is engaged in pursuant to a liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization.[33] For this exception to apply, all the securities of the same class as those held by the foundation prior to the transfer must be subject to the same terms, and these terms must provide for receipt by the foundation of no less than fair market value.[34]

Q 1:8 When does an act of self-dealing *occur*?

An act of self-dealing *occurs* on the date on which all of the terms and conditions of the transaction and the liabilities of the parties have been fixed.[35]

Q 1:9 What is the *amount involved*?

The *amount involved* generally is the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.[36]

Q 1:10 What does *correction* mean?

Correction of an act of self-dealing means undoing the transaction that constituted the act to the extent possible, but in no case may the resulting financial position of the private foundation be worse than would be the case if the disqualified person was dealing under the highest fiduciary standards.[37] This means return to the private foundation of the amount involved (Q 1:9), plus another element (usually the payment of a suitable amount of interest), so as to place the parties in the position they were in before the transaction occurred.

NOTE: For example, in the case of excessive compensation (Q 1:6, Q 3:13), correction of the act of self-dealing includes return to the foundation of the excess portion of the compensation paid.

There are special rules in this regard in the context of the additional taxes (Q 1:5):

- In the case of the additional tax imposed in connection with the mandatory distribution rules (Q 1:15), the term *correct* means reducing the amount of undistributed income to zero.[38]
- In the case of the additional tax imposed in connection with the excess business holdings rules (Q 1:19), the term means reducing the amount of the excess business holdings to zero.[39]
- In the case of the additional tax imposed in connection with the jeopardizing investments rules (Q 1:22), the term means removing the investment from jeopardy.[40]

Q 1:11 What are the penalties for self-dealing?

An initial tax is imposed on each act of self-dealing between a disqualified person and a private foundation. The tax is imposed on the self-dealer at the rate of 5 percent of the amount involved (Q 1:9) with respect to the act for each year in the taxable period or part of a period.[41] Where this initial tax is imposed, a tax of 2½ percent of the amount involved is imposed on the participation of any foundation manager in the act of self-dealing, where the manager knowingly participated in the act.[43] This tax is not imposed, however, where the participation was not willful and was due to reasonable cause.[44] This tax, which must be paid by the foundation manager, may not exceed $10,000.[45]

CAUTION: The aspect of the self-dealing penalties rules represented by the words "for each year" requires emphasis. Each year with a set of self-dealing facts extant brings a new round of penalties. In one instance involving a loan to a disqualified person—remember, an extension of credit to a disqualified person can be self-dealing (Q 1:6, Q 3:8)—the matter concerned a 40-year mortgage. The IRS observed that there was a potential in these facts for 40 separate acts of self-dealing.[42]

Where an initial tax is imposed and the self-dealing act is not timely corrected (Q 1:10), an additional tax is imposed in an amount equal to 200 percent of the amount involved. This tax must be paid by the disqualified person (other than a foundation manager) who participated in the act of self-dealing.[46] An additional tax equal to 50 percent of the amount involved, up to $10,000,[47] is imposed on a foundation manager (where the additional tax is imposed on the self-dealer) who refuses to agree to all or part of the correction.[48]

In a case where more than one person is liable for any initial or additional tax with respect to any one act of self-dealing, all of the persons are jointly and severally liable for the tax or taxes.[49]

Willful repeated violations of these rules may result in involuntary termination of the private foundation's status and the imposition of additional taxes.[50] The involuntary termination tax thus serves as a third-tier tax.

Q 1:12 What are the mandatory distribution rules?

A private foundation is required to distribute, for each year, at least a minimum amount of money and/or property for charitable purposes (Chapter 4).[51] The amount that must be distributed by a private foundation, with respect to each year, is the *distributable amount.*[52] That amount must be in the form of *qualifying distributions,* which essentially are grants, outlays for administration, and payments made to acquire charitable assets.[53]

Generally, the distributable amount for a private foundation is an amount equal to 5 percent of the value of the noncharitable assets of the foundation.[54] This is the *minimum investment return.*[55] The distributable amount also includes amounts equal to repayments to a foundation of items previously treated as qualifying distributions (e.g., scholarship loans), amounts received on disposition of assets previously treated as qualifying distributions, and amounts previously set aside for a charitable project but not so used.[56]

Q 1:13 What are the *charitable assets* of a private foundation?

The *charitable assets* of a private foundation are of two categories. One is those actually used by the foundation in carrying out its charitable objectives. The other category is assets owned by the foundation where it has convinced the IRS that their immediate use for exempt purposes is not practical and that

definite plans exist to commence a related use within a reasonable period of time.[57]

Thus, the assets that are in the minimum investment return base are those held for the production of income or for investment (e.g., stocks, bonds, interest-bearing notes, endowment funds, and leased real estate).[58] Where property is used for both exempt and other purposes, it is considered to be used exclusively for tax-exempt purposes where the exempt use represents at least 95 percent of the total use; otherwise, a reasonable allocation between the two uses is required.[59]

Q 1:14 Are there any exceptions to the mandatory distribution rules?

No, not as such. There is, however, an exception to the *timing* of distributions by a private foundation for mandatory payout purposes. This is the *set-aside,* whereby funds are credited for a charitable purpose rather than immediately granted; where the requirements are met, the set-aside is regarded as a qualifying distribution.[60]

One type of set-aside is that referenced in the *suitability test.* This requires a specific project, a payment period not to exceed 60 months, and a ruling from the IRS.[61] The other type of set-aside is the subject of the *cash distribution test.* This test entails set percentages of distributions over a multiyear period and does not require an IRS ruling.[62]

Q 1:15 What are the penalties for failure to meet the distribution rules?

An initial tax of 15 percent is imposed on the undistributed income of a private foundation that, for any year, has not been distributed on a timely basis in the form of qualifying distributions (Q 4:21).[63] In a case in which an initial tax is imposed on the undistributed income of a private foundation for a year, an additional tax is imposed on any portion of the income remaining undistributed at the close of the taxable period.[64] This tax is equal to 100 percent of the amount remaining undistributed at the close of the period.[65]

Payment of these taxes is required in addition to, rather than in lieu of, making the required distributions.[66]

The involuntary termination taxes[67] serve as third-tier taxes.

Q 1:16 What are the excess business holdings rules?

Private foundations are limited as to the extent to which they can own interests in commercial business enterprises (Chapter 5).[68] A private foundation and all disqualified persons with respect to it generally are permitted to hold no more than 20 percent of a corporation's voting stock or other interest in a business enterprise. These are *permitted holdings.*[69] If effective control of the business can be shown to be elsewhere, a 35 percent limit may be substituted for the 20 percent limit.[70] A private foundation must hold, directly or indirectly, more than 2 percent of the value of a business enterprise before these limitations become applicable.[71]

Q 1:17 Are there any exceptions to the excess business holdings rules?

There are three principal exceptions to these rules. One, the rules do not apply in the case of a business where at least 95 percent of its gross income is derived from passive sources.[72] These sources generally include dividends, interest, annuities, royalties, and capital gain.[73]

The second exception is for holdings in a *functionally related business.*[74] This is a business:

- That is substantially related to the achievement of the private foundation's exempt purposes (other than merely providing funds for the foundation's programs);
- In which substantially all the work is performed for the private foundation without compensation;
- Carried on by a private foundation primarily for the convenience of its employees;
- That consists of the selling of merchandise, substantially all of which was received by the foundation as contributions; or
- That is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that is related to the exempt purposes of the foundation.[75]

The third exception is for *program-related investments* (Q 1:21).[76]

Q 1:18 These excess business holdings rules seem strict; are there any relief provisions?

If a private foundation obtains holdings in a business enterprise, in a transaction that is not a purchase by the foundation or by disqualified persons with respect to it, and the additional holdings would result in the foundation's having an excess business holding, the foundation has five years to reduce the holdings to a permissible level without penalty.[77]

Moreover, the IRS has the authority to allow an additional five-year period for the disposition of excess business holdings in the case of an unusually large gift or bequest of diverse business holdings or holdings with complex corporate structures.[78] This latter rule entails several requirements, including a showing that diligent efforts were made to dispose of the holdings within the initial five-year period and that disposition within that five-year period was not possible (except at a price substantially below fair market value) by reason of the size and complexity or diversity of the holdings.

Q 1:19 What are the penalties for violation of the excess business holdings rules?

An initial excise tax is imposed on the excess business holdings of a private foundation in a business enterprise for each tax year that ends during the taxable period.[79] The amount of this tax is 5 percent of the total value of all of

the private foundation's excess business holdings in each of its business enterprises.[80]

If the excess business holdings are not disposed of during the period, an additional tax is imposed on the private foundation. The amount of this tax is 200 percent of the value of the excess business holdings.[81]

The involuntary termination taxes[82] serve as third-tier taxes.

Q 1:20 What are the jeopardizing investments rules?

There are rules governing the type of investments that a private foundation is allowed to make (Chapter 6).[83] In general, a private foundation cannot invest any amount—income or principal—in a manner that would jeopardize the carrying out of any of its tax-exempt purposes.[84] An investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making the investment, failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of the investment, in providing for the long-term and short-term financial needs of the foundation in carrying out its charitable activities.[85]

A determination as to whether the making of a particular investment jeopardizes the exempt purposes of a private foundation is made on an investment-by-investment basis, in each case taking into account the private foundation's portfolio in its entirety.[86] Although the IRS will not rule as to an investment procedure governing investments to be made in the future, it will rule as to a currently proposed investment.[87]

There is no category of investments that is treated as a per se violation of these rules. There are, however, types or methods of investment that are closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence. These include trading in securities on margin, trading in commodity futures, investments in oil and gas syndications, the purchase of puts and calls (and straddles), the purchase of warrants, and selling short.[88]

Q 1:21 Are there any exceptions to these rules?

A *program-related investment* is not a jeopardizing investment. This is an investment the primary purpose of which is to accomplish one or more charitable purposes, and no significant purpose of which is the production of income or the appreciation of property.[89] A purpose of the investment may not be the furthering of substantial legislative or political campaign activities.[90]

Q 1:22 What are the penalties for violation of the jeopardizing investments rules?

If a private foundation invests in such a manner as to jeopardize the carrying out of any of its charitable purposes, an initial tax is imposed on the foundation

on the making of the investment, at the rate of 5 percent of the amount so invested for each year or part of a year in the taxable period.[91]

In any case in which this initial tax is levied, a tax is imposed on the participation of any foundation manager in the making of the investment, knowing that it is jeopardizing the carrying out of any of the foundation's exempt purposes. This tax is equal to 5 percent of the amount so invested for each year of the foundation (or part of the year) in the period.[92] With respect to any one investment, the maximum amount of this tax is $5,000.[93] This tax, which must be paid by any participating foundation manager, is not imposed where the participation was not willful and was due to reasonable cause.[94]

An additional tax is imposed in any case in which this initial tax is imposed and the investment is not removed from jeopardy within the period. This tax, which is to be paid by the private foundation, is at the rate of 25 percent of the amount of the investment.[95] In any case in which this additional tax is imposed and a foundation manager has refused to agree to all or part of the removal of the investment from jeopardy, a tax is imposed at the rate of 5 percent of the amount of the investment.[96] With respect to any one investment, the maximum amount of this tax is $10,000.[97]

Where more than one foundation is liable for an initial tax or an additional tax with respect to a jeopardizing investment, all of the managers are jointly and severally liable for the taxes.[98]

The involuntary termination taxes[99] serve as third-tier taxes.

Q 1:23 What are the taxable expenditures rules?

The federal tax law provides restrictions, in addition to those discussed earlier, on the activities and purposes for which private foundations may expend their funds (Chapter 7).[100] These rules pertain to matters such as legislative activities, electioneering, grants to individuals, grants to noncharitable organizations, and grants for noncharitable purposes. Improper and, in effect, prohibited expenditures are termed *taxable expenditures.*

Q 1:24 What are the rules concerning lobbying?

One form of taxable expenditure is an amount paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation.[101] Thus, the general rule by which charitable organizations can engage in a certain amount of legislative activity[102] is inapplicable to private foundations.

Attempts to influence legislation generally include certain communications with a member or employee of a legislative body or with an official or employee of an executive department of a government who may participate in formulating legislation, as well as efforts to affect the opinion of the general public or a segment of it.[103] An expenditure is an attempt to influence legislation if it is for a *direct lobbying communication* or a *grassroots communication.*[104]

Engaging in nonpartisan analysis, study, or research and making the results of this type of undertaking available to the general public (or a segment of it) or to governmental bodies or officials is not a prohibited form of legislative activity.[105] Likewise, amounts paid or incurred in connection with the provision of technical advice or assistance to a governmental body or committee (or subdivision of it) in response to a written request from the entity do not constitute taxable expenditures.[106]

Another exception is that the taxable expenditures rules do not apply to any amount paid or incurred in connection with an appearance before or communication to a legislative body with respect to a possible decision of that body that might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deductibility of contributions to the foundation.[107]

NOTE: This is known as the *self-defense exception.*

Expenditures for examination and discussions of broad social, economic, and similar issues are not taxable even if the problems are of the types with which government would be expected to deal ultimately.[108]

Q 1:25 What are the rules concerning electioneering?

The term *taxable expenditure* encompasses an amount paid or incurred by a private foundation to influence the outcome of a specific public election or to carry on, directly or indirectly, a voter registration drive.[109] The first of these prohibitions generally parallels the prohibition on political campaign activities by all charitable organizations.[110]

A private foundation may, however, engage in electioneering activities (including voter registration drives) without making a taxable expenditure, where a variety of criteria are satisfied, such as not confining the activity to one election period and carrying it on in at least five states.[111]

Q 1:26 What are the rules concerning grants to individuals?

The term *taxable expenditure* also encompasses an amount paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes.[112] This type of grant is not prohibited, however, if it is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the IRS, and if the IRS is satisfied that the grant is one of three types. These are:

1. A scholarship or fellowship grant that is excludable from the recipient's gross income and used for study at an educational institution
2. A prize or award that is excludable from the recipient's gross income, where the recipient is selected from the general public

3. A grant for which the purpose is to achieve a specific objective, produce a report or similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee[113]

The requirement as to objectivity and nondiscrimination generally necessitates that the group from which grantees are selected be chosen on the basis of criteria reasonably related to the purposes of the grant. The group must be sufficiently broad so that the making of grants to members of the group would be considered to fulfill a charitable purpose.[114] The individual or group of individuals who select grant recipients should not be in a position to derive a private benefit as the result of the selection process.[115]

These rules as to individual grants generally require:

- The receipt by a private foundation of an annual report from the beneficiary of a scholarship or fellowship[116]
- That a foundation investigate situations indicating that all or a part of a grant is not being used in furtherance of its purposes[117]
- Recovery or restoration of any diverted funds, and withholding of further payments to a grantee in an instance of improper diversion of grant funds[118]

A private foundation must maintain certain records pertaining to grants to individuals.[119]

Q 1:27 What are the rules concerning grants to noncharitable organizations?

A private foundation may make grants to an organization that is not a public charity. When it does so, however, it must exercise *expenditure responsibility* with respect to the grant.[120] A private foundation is considered to be exercising expenditure responsibility in connection with a grant as long as it exerts all reasonable efforts and establishes adequate procedures to see that the grant is spent solely for the purpose for which it was made, obtains full and complete reports from the grantee on how the funds were spent, and makes full and detailed reports with respect to the expenditures to the IRS.[121]

Q 1:28 What are the rules concerning grants for noncharitable purposes?

The term *taxable expenditure* encompasses an amount paid or incurred by a private foundation for a *noncharitable* purpose.[122] Ordinarily, only an expenditure for an activity that was a substantial part of the organization's total activities, and that would cause loss of tax exemption, is a taxable expenditure.[123]

Expenditures ordinarily not treated as taxable expenditures are:

- Expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of charitable purposes
- Reasonable expenses with respect to investments
- Payment of taxes
- Any expenses that qualify as deductions in the computation of the unrelated business income tax (see Chapter 9.)
- Any payment that constitutes a qualifying distribution (Q 4:10) or an allowable deduction pursuant to the investment income tax rules (Q 8:15)
- Reasonable expenditures to evaluate, acquire, modify, and dispose of program-related investments (Q 6:7)
- Business expenditures by the recipient of a program-related investment

Conversely, expenditures for unreasonable administrative expenses, including compensation, consultants' fees, and other fees for services rendered, are ordinarily taxable expenditures, unless the private foundation can demonstrate that the expenses were paid or incurred in the good-faith belief that they were reasonable and that the payment or incurrence of the expenses were in amounts consistent with ordinary care and prudence.[124]

Q 1:29 What are the penalties for violation of the taxable expenditures rules?

An excise tax is imposed on a taxable expenditure of a private foundation, which is to be paid by the foundation at the rate of 10 percent of the amount of the taxable expenditure.[125] An excise tax is imposed on the agreement of any foundation manager to the making of a taxable expenditure by a private foundation.[126] This latter initial tax is levied only where the private foundation initial tax is imposed, the manager knew that the expenditure to which he or she agreed was a taxable one, and the agreement was not willful and was due to reasonable cause. This initial tax, which is at the rate of 2½ percent of each taxable expenditure, must be paid by the foundation manager.[127]

An excise tax is imposed in any case in which an initial tax is imposed on a private foundation because of a taxable expenditure and the expenditure is not corrected (Q 1:10) within the taxable period. This additional tax is to be paid by the private foundation and is at the rate of 100 percent of the amount of the taxable expenditure.[128] An excise tax, in any case in which an initial tax has been levied, is imposed on a foundation manager if there has been a taxable expenditure and the foundation manager has refused to agree to part or all of the correction of the expenditure. This additional tax, which is at the rate of 50 percent of the amount of the taxable expenditure, is to be paid by the foundation manager.[129]

When more than one foundation manger is liable for an excise tax with respect to the making of a taxable expenditure, all the foundation managers are jointly and severally liable for the tax.[130] The maximum aggregate amount collectible as an initial tax from all foundation managers with respect to a taxable expenditure is $5,000; the maximum aggregate amount so collectible as an additional tax is $10,000.[131]

The second-tier excise taxes are imposed at the end of the taxable period. This period begins with the event giving rise to the expenditure tax and ends on the earlier of (1) the date a notice of deficiency with respect to the first-tier tax is mailed or (2) the date the first-tier tax is assessed if a deficiency notice is not mailed.[132]

The involuntary termination taxes[133] serve as third-tier taxes.

Q 1:30 Can these initial taxes be abated?

Generally, yes. Where the IRS is satisfied that (1) a *taxable event* was due to reasonable cause and not to willful neglect and (2) the event was corrected within the *correction period* for the event, then

- An initial tax imposed with respect to the event (including interest) will not be assessed.
- If the tax is assessed, the assessment will be abated.
- If the tax is collected, it will be credited or refunded as an overpayment.[134]

As noted (Q 1:5), these taxes are often referred to as the *initial taxes.* They are also sometimes referred to as the *first-tier taxes.*[135] In the abatement context, however, the taxes must be *qualified first-tier taxes.*[136]

CAUTION: The word *qualified* is a part of this terminology for a special reason: The IRS's abatement authority does not extend to the initial tax imposed in the self-dealing setting (Q 1:11).[137]

For these purposes, a *taxable event* is an act, or a failure to act, that gives rise to liability for tax under the various private foundation rules (Q 1:4).[138] The *correction period* is, with respect to a taxable event, the period beginning on the date the event *occurs* (Q 1:31) and ending 90 days after the date of mailing[139] of a notice of deficiency with respect to the additional tax imposed on the event.[140] This period may be extended by (1) a period in which a deficiency cannot be assessed[141] and (2) any other period that the IRS determines is reasonable and necessary to bring about correction of the taxable event.[142]

Q 1:31 When does a taxable event *occur*?

There are three rules for determining when a taxable event *occurs.* Two of these rules are unique to particular private foundation rules and one is general.

1. In the case of the mandatory distribution rules (Q 1:12), a taxable event is treated as occurring on the first day of the year for which there was a failure to distribute income.[143]
2. In the case of the excess business holdings rules (Q 1:16), the taxable event is treated as occurring on the first day on which there are excess business holdings.[144]
3. In all other instances, the taxable event is treated as occurring on the date the event actually occurred.[145]

Q 1:32 Can these additional taxes be abated?

Yes, under certain circumstances. As noted (Q 1:5), these taxes often are referred to as the *additional taxes.* They also are sometimes referred to as the *second-tier taxes.*[146]

The abatement rule in this context is this: If a taxable event (Q 1:31) is corrected (e.g., Q 1:10) during the applicable correction period (Q 1:30), then, as to any additional tax imposed with respect to the event (including interest, additions to the tax, and additional amounts):

- An additional tax imposed with respect to the event (including interest) will not be assessed.
- If the tax is assessed, the assessment will be abated.
- If the tax is collected, it will be credited or refunded as an overpayment.[147]

If there is a determination by a court that a person is liable for an additional tax, and that determination has become final, the court has jurisdiction to conduct any necessary supplemental proceedings to determine whether the taxable event was corrected during the correction period. There are rules as to when these and other proceedings must begin and when they must be suspended.[148]

Q 1:33 Are there other private foundation rules?

Yes, there are more. An excise tax of 2 percent is generally imposed on the net investment income of private foundations for each tax year (Chapter 8).[149] This tax must be estimated and paid quarterly, generally following the estimated tax rules for corporations.[150] Under certain circumstances, this tax rate is reduced to 1 percent in a year where the foundation's payout for charitable purposes (Q 1:12, Q 8:18) is increased by an equivalent amount.[151]

As to certain of the private foundation rules, nonexempt charitable trusts[152] and split-interest trusts[153] are treated as private foundations.[154]

A 4 percent tax is imposed on the gross investment income derived from sources within the United States by foreign organizations that constitute private foundations.[155]

Q 1:34 Is there more than one type of private foundation?

Yes. The entity that is normally thought of when the term *private foundation* is used is the *standard* private foundation. This is the typical grant-making private foundation. The standard private foundation essentially has, as noted (Q 1:1), four characteristics.

Private Operating Foundation

There is a hybrid entity—a blend of the characteristics of a public charity (Q 1:2) and a private foundation—known as the *private operating foundation.* These are organizations that, while not qualifying as public charities, devote most of their earnings and much of their assets directly to the conduct of their own tax-exempt purposes. That is, they make qualifying distributions (Q 1:12) directly for the active conduct of charitable activities.[156]

> **NOTE:** The basic distinction, then, between a standard and an operating foundation is this matter of distributions. The private operating foundation makes its required charitable expenditures by sponsoring and managing its own programs. The standard private foundation makes grants to other organizations.

Typically, a private operating foundation is an entity that should be a public charity but cannot qualify as such because it is not one of the institutions (Q 1:2) and has a large endowment that precludes it from being a publicly supported organization (*id.*). Classic examples are museums and libraries.

To be considered as *operating,* the foundation must focus and spend a specified annual amount on one or more projects in which it is significantly involved in a continuing and sustainable fashion. The requisite involvement is, as a general rule, found to be present where the foundation's expenditures are made directly or used by it to purchase the goods and services that advance its purposes, rather than being paid to or indirectly through an intermediary organization.

A typical private operating foundation, being significantly involved in its programs, maintains a staff (which may be or include volunteers) of program specialists, researchers, teachers, administrators, or other comparable personnel needed to supervise, direct, and carry out its programs on a continuing basis. This type of foundation usually acquires and maintains assets used in its programs, such as buildings, collections of art objects or specimens, or research facilities. Qualifying direct expenditures also include the purchase of books and publications, supplies, computer programs, and project costs (i.e., food in the case of an organization feeding the poor and travel and equipment in the instance of an organization pursuing archeological studies).

To be a private operating foundation, the organization must satisfy an *income test.* Annually, it must expend directly, for the active conduct of its

exempt activities, an amount equal to substantially all of the lesser of its adjusted net income or its minimum investment return.[157] In this setting, the phrase *substantially all* means at least 85 percent.[158] As noted, the minimum investment return is equal to 5 percent of the foundation's assets that are not used for charitable purposes (Q 1:12).

To qualify as a private operating foundation, an organization must satisfy at least one of three other tests:

1. The *assets test*: At least 65 percent of its assets must be devoted directly to the active conduct of its charitable activities.[159]
2. The *endowment test*: The organization must normally expend its funds directly for the active conduct of its charitable activities in an amount equal to at least two-thirds of its minimum investment return ($\frac{2}{3} \times 5 = 3\frac{1}{3}$).[160]
3. The *support test*: At least 85 percent of its support (other than investment income) must be normally received from the general public and/or at least five tax-exempt organizations (that are not disqualified persons); no more than 25 percent of its support can be derived from any one exempt organization; and no more than one-half of its support can be normally received in the form of gross investment income.[161]

Because of these rules, a private operating foundation is not subject to the minimum payout requirement imposed on standard private foundations (Q 1:12). Contributions to a private operating foundation are deductible to the full extent permitted for gifts to public charities. (See Chapter 12.) That is, the percentage limitations that restrict the deductibility of contributions to standard private foundations (Q 1:41) do not apply to gifts to private operating foundations.

Exempt Operating Foundation

Not content with the complexity introduced with the hybrid form of private foundation known as the private operating foundation, Congress created a hybrid of a hybrid. This entity is known as the *exempt operating foundation*.[162]

NOTE: The word *exempt* does not mean exempt from federal income taxes (which private foundations generally are in any case).

Exempt operating foundations are presumably otherwise private operating foundations, but they enjoy two characteristics that the others do not have:

1. Grants to an exempt operating foundation are exempt from the expenditure responsibility requirements otherwise imposed on grantor foundations (Q 7:24).
2. An exempt operating foundation does not have to pay the tax imposed on other private foundations' net investment income (Chapter 8).

NOTE: This, then, is the meaning of the word *exempt*: These operating foundations are exempt from these requirements and taxes.

To be an exempt operating foundation, an organization must (in addition to satisfying the requirements to be a private operating foundation) meet three tests:

1. It must have been publicly supported (Q 12:4, Q 12:8) for at least 10 years or have qualified as an operating foundation as of January 1, 1983.
2. It must have a board of directors that, during the year involved, consists of individuals at least 75 percent of whom are not *disqualified individuals* and was broadly representative of the general public (presumably using the facts and circumstances test (Q 12:5)).
3. It must not have an officer who is a disqualified individual at any time during the year involved.

These rules were written for the entities that are not really private foundations (the standard variety) but cannot meet the formal qualifications for public charity status—again, endowed entities such as museums. This approach is a compromise for them: They are treated as public charities in the sense that private foundation support for them does not trigger the expenditure responsibility requirements, and they do not have to pay the tax on net investment income.

COMMENT: Perhaps someday Congress will enact federal tax law provisions providing public charity status for entities such as museums, libraries, and like entities. The difficulty, of course, is the need to write these rules in sufficiently narrow fashion, if the original congressional intent in creating the private foundation rules is to be preserved.

NOTE: This area of the law, then, may be perceived as a spectrum, with standard private foundations on one end, followed by private operating foundations, followed by exempt operating foundations, followed by various forms of public charities. One of the anomalies of this law is that an organization that is able to qualify as an exempt operating foundation often is able to qualify under the facts and circumstances test (Q 12:5)—and thereby avoid all of the private foundation rules!

Q 1:35 Are private foundations subject to the unrelated business rules?

Yes. These rules do not often apply to private foundations, however, because foundations cannot actively engage in unrelated business undertakings; if they

did, the activity would be an excess business holding, such as a sole proprietorship (Q 1:16).

The federal tax law imposes a tax on organizations that derive net income from activities that do not further their exempt functions.[163] This income is called unrelated business income ("UBI"). Pursuant to the general rules, UBI is generated if (1) the activity constitutes a trade or business[164]; (2) the trade or business is regularly carried on[165]; and (3) the trade or business is not substantially related to the organization's exempt purposes.[166]

Private foundations, nonetheless, can derive unrelated business income from passive sources. Thus, the excess business holdings rules do not extend to a business where at least 95 percent of its income is passive, such as dividends, interest, annuities, royalties, and capital gains (Q 1:17).

A private foundation's primary UBI risk may well relate to the development of real property it acquired by gift. There may be several parcels of real property that should be further developed to maximize their respective values. The subdivision and development of certain parcels of real property may be viewed by the IRS as a trade or business resulting in recognition of UBI when the parcels are sold. If multiple sales and significant development occurs, the foundation may be viewed as a dealer in the real property rather than an investor. The foundation's sale of parcels that are treated as its inventory will be subject to the tax on UBI, whereas the sale of investment property would be exempt from UBI taxation by reason of the exclusion for capital gains.[167]

There is no bright-line test to determine when the real property shifts from investment property to inventory and, therefore, becomes subject to UBI taxation. The IRS and the courts utilize a facts and circumstances test to determine whether the tax-exempt organization in this circumstance is a dealer. Such factors as (1) the purpose of the acquisition, (2) the cost of property sold, (3) frequency, continuity, and size of sales, (4) sales activities, (5) improvements made, (6) the proximity of time of sale and time of purchase, (7) purpose for acquisition, and (8) market conditions will be analyzed in this regard. Many planning opportunities exist to maximize value while minimizing the tax paid, including the use of an installment sale approach and use of a for-profit subsidiary to develop the property. A for-profit subsidiary may not be utilized by a private foundation (because of the excess business holdings rules) but would be available were there a conversion of the foundation to public charity status (Q 1:2).

Q 1:36 Are private foundations required to file annual information returns with the IRS?

Yes. Every private foundation is required to file an annual information return with the IRS (Chapter 10).[168] This return is on Form 990-PF. Tax-exempt organizations generally have some exceptions in this area, such as for small organizations (i.e., those that normally receive more than $25,000 in revenues annually[169]). This is not the case with foundations; all foundations, including those without revenues or assets, are obligated to file.

This annual information return has several functions. It solicits the basic financial information—revenue, disbursements, assets, and liabilities—that is classified into meaningful categories to allow the IRS to statistically evaluate the scope and type of foundation activity, to measure the foundation's taxable investment income, and to tally the disbursements counted in connection with the foundation's minimum payout requirement.

The form has special parts containing questions designed to ferret out instances of noncompliance with the various federal tax law requirements, such as excessive compensation, other forms of self-dealing, inadequate payouts, excessive business holdings, jeopardizing investments, and taxable expenditures.

Q 1:37 Are private foundations subject to document disclosure and dissemination rules?

Yes. Private foundations are subject to the rules applicable to all tax-exempt organizations, by which their application for recognition of tax exemption and their three most recent annual information returns may be inspected at the foundation's office(s) during regular business hours (Chapter 11).[170] Foundations are also subject to relatively recent document dissemination rules, pursuant to which photocopies of these documents must be provided to those who request them (*id.*).

NOTE 1: The document dissemination rules do not apply where the organization makes them "widely available" (i.e., accessible on the Internet) or where the request is part of a "harassment campaign."

NOTE 2: The effective date for the document dissemination rules for tax-exempt organizations generally was June 8, 1999.[171] The effective date for these rules as applicable to private foundations was March 13, 2000.[172]

Q 1:38 Can a private foundation terminate its private foundation status?

Yes. A private foundation can voluntarily terminate its private foundation status (Chapter 13). There are essentially two ways to accomplish this type of termination:

1. The foundation can terminate its status as an entity. This is done by a distribution of all of its net assets to one or more qualified public charities, as long as each of them has been in existence (as a public charity) for a continuous period of at least 60 calendar months.[173]
2. The organization can convert to a public charity (Q 1:2). It must satisfy the rules of the public charity status it selected for an initial continuous period of 60 calendar months.[174]

NOTE: These options are not available to a private foundation where there have been either willful repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under one or more of the private foundation rules (Q 1:4).[175]

Q 1:39 Are private foundations subject to the private inurement doctrine?

Yes, they most certainly are. All tax-exempt charitable organizations[176] are subject to the *private inurement doctrine.* This is the rule of law that prohibits charitable organizations from inappropriately distributing their net income and/or net assets to persons in their private capacity. A private foundation, being such a charitable organization, is bound by the private inurement doctrine. The sanction for violating the private inurement doctrine is revocation of tax-exempt status.

As a matter of practice, however, the IRS or a court is far more likely to impose one or more taxes for self-dealing (Q 1:6) in an instance of a private inurement transaction than adhere to the stricter dictates of the private inurement doctrine. At the same time, in an egregious set of circumstances, both the self-dealing rules and the private inurement doctrine may be invoked.

Q 1:40 Are private foundations subject to the private benefit doctrine?

Yes. There is, however, only one published instance of application of the doctrine in the private foundation setting. There, the IRS applied the *private benefit doctrine,* holding that even though a transaction did not amount to self-dealing, it would constitute an impermissible private benefit.[177]

An organization, to be a tax-exempt charitable one, must not offer private benefit, unless it is merely incidental. A single non-exempt purpose, if substantial, can lead to loss of tax-exempt status. There is no need of the presence of an *insider* (disqualified person). In the private benefit setting, impermissible non-incidental benefits can be conferred on disinterested persons where the benefits serve private interests.

In the facts of this case, a private foundation was the owner of a collection of original documents and other materials created by or related to an individual (G), and his wife and children. This collection was only partially catalogued and organized; access to these materials was generally limited. Portions of the collection were in fragile condition and conservation efforts had to be undertaken before any further public use of it could be considered. The foundation was planning on transferring the collection to a public charity.

Another individual (F) requested access to and copies of portions of the collection for the purpose of writing a book concerning G. F was an author who was writing a book about G. She requested access to the collection to research primary material for the book. Her book was not requested or

authorized by the foundation. This book project was to be a commercial one. F was to hold the copyright on the book and all other proprietary rights. The private foundation was not to compensate for F's use of the collection.

A third individual (H) was the founder of and a substantial contributor to the foundation (and thus was a disqualified person with respect to it (Q 2:2)). F was a great niece of H. She also was a great granddaughter of G (who was not a substantial contributor to the foundation). F was not a trustee of the foundation, nor was she the child or grandchild of any trustees. She was the niece, sibling, or cousin of trustees. F was not the owner of more than 20 percent of the voting power, profit interest, or beneficial interest of any entity that was a substantial contributor to the foundation. Although F held positions on advisory committees of the private foundation, she did not have the power to vote on any action of the foundation.

F was not a disqualified person with respect to this private foundation. She was not a foundation manager, a substantial contributor, a 20 percent owner, or a family member. Basically, her relationship with the private foundation was too distant for her to be considered a disqualified person.

The IRS ruled that, in this case, the private foundation would confer impermissible private benefit to F by giving her preferential exclusive access to the collection. F's private interests would be served by allowing her to profit commercially in that the book about G would be enhanced by information found about G in the collection. Thus, the IRS held, the foundation would be jeopardizing its tax-exempt status if it acceded to F's request.

COMMENT: With some tinkering with the facts, the outcome in this case could be different. For example, if F paid the foundation fair value for access to the collection, there would not be private benefit. Or, if the book project was that of the foundation, rather than a commercial one, the outcome would be different. Far more important, however, is this fine example of how the private benefit doctrine applies in the private foundation setting. This is another of the traps to be found in the foundation context. Consider this: If a transaction is between a private foundation and a disqualified person, then, under the general rules at least, the transaction would be self-dealing (Chapter 3). If, however, a disqualified person is not in the picture, the transaction may nonetheless amount to self-dealing. This is because a self-dealing transaction includes a transaction that creates a use or benefit for a disqualified person (Q 3:20). This ruling illustrates that the analysis should not stop even if the facts show that there is no disqualified person or benefit created for the use of a disqualified person. That is, nonetheless, there may be impermissible private benefit. This shifts the sanction away from the disqualified person (an excise tax) and on the foundation (revocation of tax exemption). Thus, in this area, all three of these levels of analysis may have to be—carefully—made.

Q 1:41 Are contributions to private foundations deductible?

Absolutely. Private foundations are charitable organizations (Q 1:39) and thus are able to attract contributions that are deductible for federal income, estate, and gift tax purposes (Chapter 17).[178] Usually charitable deductions are also available under state law.

The difficulty in the income tax setting is the *extent* of gift deductibility. For the most part, the tax rules in this regard favor gifts to public charities (Q 1:2). The major determining factor in this context is the nature of the thing that is the subject of the gift. In the case of individuals, there are percentage limitations, annually applied to adjusted gross income, which can restrict the amount of charitable giving that is deductible in a year.

Thus, an individual can deduct an amount equal to as much as 50 percent of adjusted gross income in the case of one or more gifts of money to one or more public charities.[179] For example, if an individual has adjusted gross income of $100,000 in a year, he or she can make deductible gifts of money to public charities in that year up to $50,000. (Any excess can be carried forward and deducted in subsequent years, up to five.[180]) Contributions of money to private foundations, however, are subject to a 30 percent limitation.[181] (Again, carryovers are available.[182])

An individual can deduct an amount equal to as much as 30 percent of adjusted gross income in the case of one or more gifts of property to one or more public charities.[183] For example, if an individual has adjusted gross income of $100,000 in a year, he or she can make deductible gifts of property to public charities in that year up to $30,000.

NOTE: Where a special election is made, contributions of capital gain property may be subject to the 50 percent limitation rather than the 30 percent limitation.[184]

Contributions of this type to private foundations, however, are subject to a 20 percent limitation.[185] (Carryovers are available in both instances.[186])

Generally, contributions of property (including property that has appreciated in value) to public charities give rise to charitable deductions based on the fair market value of the property at the time of the gift.[187] At the same time, however, property gifts to private foundations generally yield a charitable deduction equal to only the donor's basis in the property.[188]

NOTE: There is a special rule, nonetheless, by which a contribution of most publicly traded securities to a private foundation gives rise to a charitable deduction based on the fair market value of the securities.[189]

Q 1:42 Is there any advantage to classification as a private foundation?

There certainly is no advantage *from the standpoint of the law* as to private foundation status. In every way, the federal tax law favors public charities (Q 1:22).

Nonetheless, there are advantages to classification as a private foundation. The principal one is *control.* An individual, couple, family, corporation, or the like can make one or more gifts to the foundation and retain control over the investment and distribution of funds. The individual or individuals who established the foundation can serve on its board of trustees (without limitation) and enjoy the personal benefits that flow to those who are philanthropists. A private foundation can be a source of employment for those who created it and for their children and subsequent generations.

NOTE: Of course, these advantages also can be obtained where the charitable organization involved is a public charity.

Q 1:43 Is there any disadvantage to classification as a private foundation?

Yes. From the standpoint of the law, there are eight disadvantages. The importance of any of them largely depends on the circumstances of the particular charitable organization.

1. Private foundations must comply with the private foundation rules or suffer penalties (Q 1:4).
2. Private foundations are required to pay a tax on their net investment income (Q 1:33).
3. Contributions to private foundations are likely to be less deductible than gifts to other types of charities (Q 1:41).
4. The charitable deduction for a gift of appreciated property to a private foundation generally is confined to its basis rather than the full fair market value of the property (*id.*), although this disadvantage is somewhat ameliorated by the special treatment accorded *qualified appreciated securities* (*id.*).
5. Private foundations have greater limitations on their ability to generate unrelated business income (Q 1:35).
6. Private foundations are required to file a more complex annual information return (Q 1:36).
7. More extensive record keeping requirements are involved.[190]
8. The organization probably cannot be funded by private foundations because of the requirement that grants of this nature be the subject of expenditure responsibility (Q 7:24).

Q 1:44 Are the private foundation rules generally understood?

Unfortunately, no. One would think that, by now—since these rules have been in existence for over 30 years—the private foundation rules would be mastered, both by the professional community and at least basically by the public, including the media. But matters have not worked out that way.

Two examples involving the media make the point. The *Kansas City Star,* in an article published in June 1998, summarized most of the criticisms leveled at private foundations these days. One of these complaints is that the annual mandatory payout (Q 1:12) is inadequate. In the process, the journalist attempted to state that rule; it came out this way: Private foundations must give away at least "5 percent of their total assets each year."[191] Were that true, a foundation would disappear after its first 20 years or so. (To reiterate, the rule essentially is that, for a year, grants must be made out of income in an amount *equal to* at least 5 percent of noncharitable assets.)

Another journalist fared far worse, however. The *Oregonian,* in an article published the same month, stated: "Self-sufficient and self-governing, the boards that govern foundations answer to no one."[192] The IRS and not a few courts, though, think otherwise. "And foundations don't pay a dime in taxes." Other than the tax on investment and unrelated income, that is (Q 1:30). "Their only requirement is to give away at least 5 percent of their assets each year to keep their nonprofit status." That is hardly the *only* requirement the law imposes on private foundations; their nonprofit status has nothing to do with this rule. As for the botching of the payout rule, see the preceding paragraph.

COMMENT: The law concerning private foundations is indeed complex. Nonetheless, although media scrutiny is to be applauded, journalists need to do a much better job in understanding the complicated and stringent legal environment in which foundations are forced to function.

Q 1:45 Do developments in the law concerning intermediate sanctions have an impact on the private foundation rules?

Very much so. The intermediate sanctions rules[193] are, in many ways, based on the private foundation rules. This is particularly the case with respect to the self-dealing rules. There are, however, other concepts that have been imported into the intermediate sanctions rules from the private foundation area. These include the principles of the tiers of taxation, the amount involved, and correction.

Thus, a development in the law in the intermediate sanctions context can have a meaningful impact on the comparable point of law in the private foundation setting.