FOUNDATIONSOURCE

WEBINAR

Managing Risk: Best Practices for Private Foundation Compliance

Q&A SUMMARY

A private foundation provides donors with tax savings and maximum flexibility and control with their giving. However, foundations are subject to Internal Revenue Service rules and regulations. Knowing the basics of these requirements can help your foundation stay compliant, avoid hefty penalties and public scrutiny, and meet your philanthropic mission.

At a recent industry webinar hosted by *Trusts & Estates* magazine, **Jeffrey Haskell, Foundation Source's chief legal officer,** detailed the regulatory landscape and how foundations can educate themselves on the requirements.

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Although IRS rules are complex, private foundations can turn to experts like Haskell and others at Foundation Source for assistance. Understanding the rules helps you see what issues might require additional support. What follows are the highlights of Haskell's presentation.

As a foundation starts to learn about community challenges and deliver immediate support, how can they begin to address longer-term needs?

Foundations and public charities are both 501(c)(3) charitable organizations. But private foundations' funding doesn't come from the public at large. It typically comes from private sources such as an individual, a family, or a business. As such, a foundation isn't accountable to the general public in the same way that a public charity is.

But there are tax rules that make private foundations accountable to the IRS and require them to make their annual returns open to public inspection. In fact, a foundation's returns are available on any number of websites at no charge, and the public can see what expenses were incurred, how much was paid, and the names of the charities that received foundation grants.

What fiduciary rules must the board members of private foundations adhere to?

The board of a private foundation focuses on the high-level strategy, oversight, and accountability of the organization. This contrasts with officers, employees, or managers who oversee the nonprofit's day-to-day operations. The board is typically responsible for appointing the organization's officers. Board members have fiduciary duties.

There are three types of fiduciary duties that are applicable to directors of a corporation, which are nearly identical to the duties applicable to trustees. The first is the duty of care, under which directors are expected to take care of the foundation by ensuring prudent use of all its assets, including facilities, staff, and goodwill.

Second, they have the duty of loyalty. The directors must place the foundation's interests ahead of their own and at all times.

Third, they have the duty of obedience. Directors are to ensure that the foundation complies with applicable laws and regulations and that it follows its own bylaws and adheres to its stated mission.

What are the basic compliance rules that every board member must know about, particularly when it comes to self-dealing?

The IRS's self-dealing rules govern transactions between the foundation's insiders known as disqualified persons, or DPs, and private foundations. Notably, the self-dealing rules prohibit even those transactions that would be beneficial to a foundation, such as a disqualified person's sale of property to a foundation at a below-market sweetheart price. In addition to knowing the types of transactions that could result in a violation, it's also important to know the exceptions to the rules so that you're not unnecessarily limiting yourself or the foundation.

Because self-dealing rules only apply to transactions with DPs, the crux of the matter is to understand who and what is a DP. Disqualified persons are those who are actually serving on the foundation, such as the foundation's officers, directors, and trustees, as well as substantial contributors to the foundation, businesses in which the disqualified persons collectively have a significant ownership stake, and certain family members of DPs. Remember, it's not just human beings who can be considered disqualified persons, but entities too.

What kind of penalties can disqualified persons (self-dealers) face if they violate those rules?

A violation leads to a first-tier penalty and a requirement that the violation be corrected. That may mean unwinding the transaction, returning interest or rent paid, vacating rental space, or taking some other corrective action. The penalty is 10% of the "amount involved." Depending upon the nature of the transaction, the amount involved can vary. In the case of a loan, the amount involved is generally the greater of the interest paid and the prevailing federal rate during the loan. By contrast, in the case of a sale, the amount involved is the greater of the value given or received. For example, let's say a disqualified person sold a ranch to the foundation in 2020 for $5 million, its fair market value. In that case, the disqualified person will owe a $500,000 penalty.

If the transaction isn't corrected before the end of the year, another $500,000 penalty will be assessed for 2021, and so on, for each succeeding year until there's been a correction. Ultimately, if the disqualified person refuses to unwind the sale or take other corrective action, the IRS can charge the disqualified person a second-tier penalty of 200% of the amount involved, or $10 million in this case.

Then there's the ultimate doomsday scenario penalty, which the IRS can assess in a case where there are flagrant and repeated violations. The IRS could say, "Enough is enough," and terminate the foundation's status and pull in all its assets.

What do foundations need to know about the rules around payouts?

There's a minimum 5% annual distribution requirement on foundations that can be satisfied by making grants and by paying certain qualifying expenses. If a foundation pays out more than it's required in any given year, any excess can be carried forward for up to five years and applied to satisfy a future year's distribution requirement.

There is a 30% penalty on any shortfall, but there are no manager-level penalties. As with several of the other foundation compliance rules, this penalty will be relentlessly assessed each year until the violation has been corrected. If it's not corrected in a timely manner, the penalty can increase to as much as 100% of the shortfall.

Also, be on the lookout for what I call "cash flow drag." If you have an asset that doesn't produce an income stream, the foundation's annual minimum payout requirement will be driven at least in part by that asset's value.

What are excess business holdings?

Congress wanted foundations to remain focused on their charitable missions, not on the concerns a large stakeholder would normally have in running a successful business. Therefore, Congress enacted the excess business holdings rules, which place a cap on the collective percentage of ownership that a foundation and its DPs can have in a business enterprise.

The default cap is typically 20%, but under certain circumstances, this may be increased to 35%. There is a five-year grace period in connection with any lifetime gifts or bequests of ownership interests in active businesses that might otherwise have resulted in an excess business holding violation.

Although an ownership interest in a passive investment vehicle is not subject to the excess business holding rules, a foundation may be deemed to have an indirect ownership interest in a downstream business enterprise that's held by the investment vehicle. For example, let's say a foundation owns 100% of a passive holding company and that company owns 50% of an active business. In that case, a foundation would be deemed to have a 50% indirect ownership interest in the business.

A private foundation that invests exclusively in publicly traded securities typically doesn't have to worry about this type of violation because it's rare to own more than a 2% interest. This is really more of a concern when you have a foundation investing in privately held companies. If the foundation owns more than a 2% interest (by vote and value) in an active business, what you need to do is aggregate the holdings of the foundation and all of its DPs to see if their pooled interest exceeds the permissible cap, usually 20% of the company's voting stock.

What do foundations need to know about the duty of business care and prudence?

Directors and trustees have a fiduciary responsibility to follow prudent investor standards, including requirements for diversification.

These rules are not applied in hindsight. They're applied on the basis of what the foundation's investors knew at the time they made the investment. A foundation may choose one investment over another, even if the chosen investment generates a lower rate of return, so long as it aligns with or furthers a foundation's mission better than the other option.

There is a first-tier tax for both the foundation and the foundation's managers if these rules aren't followed, but the manager tax applies only if the manager willfully made the investment knowing that it constituted a jeopardizing investment. Now, to avoid the possibility of making a jeopardizing investment, foundation managers should be sure to follow the prudent investor rules.

The foundation's managers should document, possibly with the help of an advisor, that they made the investment in compliance with the foundation's investment policy and the prudent investor rules. I've seen foundations hold special board meetings when they make a very large and risky investment so that it's reflected in the minutes. They want to document the reasons they made the investment and why they think that it's prudent.

What are the rules around expenditures?

The general rule is that all private foundation expenditures must be made for charitable purposes. However, some types of expenditures are prohibited, such as those involving lobbying, electioneering, and voter registration drives. While a foundation can make grants to most charities that are classified by the IRS as public charities without any special oversight, grants made to other types of organizations generally are permissible only if certain procedures are followed. For example, grants made to domestic or foreign organizations that are not public charities can be made by following special procedures, known as expenditure responsibility.

If a foundation wishes to make a grant to a foreign charity, a non-governmental organization (NGO), the alternate approach known as an equivalency determination may be a viable option.

The rules around grants to individuals are even more complicated. Can you explain them?

When making grants to individuals, the first thing a private foundation has to do is determine whether advance IRS approval is needed. There are two types of grants to individuals that do not require IRS approval. The first is grants to individuals for the purpose of alleviating human suffering. The other is grants to individuals made in recognition of past accomplishments. It's for what they've already done, not what they're going to do.

Then there are grants to individuals that do require IRS approval. The first type is any scholarship or fellowship grant, whether it's made directly to the individual or to an educational institution. Next are grants to individuals to achieve a specific objective, produce a report, or similar product. Lastly, grants made to improve or enhance an individual's literary, artistic, musical, scientific, teaching or similar capacity, skill, or talent. I remember one case where we had a YouTuber who was developing educational content and that counted as achieving an objective, which did require IRS approval.

Once the IRS approves the grantmaking program, the foundation can continue making grants to individuals indefinitely under that program, provided it doesn't change the attributes of the program.

There are a number of universal rules that apply when granting to individuals regardless of whether advance IRS approval is necessary. First, in no event can a foundation make a grant to a disqualified person as self-dealing would result.

Also, grantees must be selected from a broad charitable class, meaning that the group must be large enough to ensure that the number of individuals in the class isn't fixed. You could say, "I want to provide scholarships to the graduating class of 2023." That's pretty finite and likely not permissible. Instead, you could have "the graduating class of 2023 and future classes from that particular high school." That's open-ended and constitutes a charitable class because you don't know who's going to be graduating from that high school in future years.

Additionally, the foundation's eligibility and selection criteria must be reasonably related to the purpose of the grant. For example, if the purpose of the grant program is to provide education to those struggling with financial limitations, it wouldn't make sense to limit eligibility to those who have red hair and green eyes.

And this goes without saying, but grantees have to be selected on a fair and even-handed basis. And the foundation has to develop a means to publicize the program. After all, if no candidates are referred to the foundation and nobody applies for help because the only people who know about the foundation's program are the foundation's own officers and directors, then how can you say that the grantees are selected from a broad charitable class?

This is a condensed, edited version of the conversation. Get full insights by watching the entire video of the presentation here.

ABOUT FOUNDATION SOURCE

Foundation Source empowers people and companies to create a better world through philanthropy. We make giving easier for more than 2,000 foundations with innovative technology backed by philanthropic expertise.

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