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FORsights on Foundations

Tax Compliance – Avoiding Pitfalls & Anticipating Potential Change

November 22, 2022

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Introductions

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Agenda

- Introductions
- Common Tax Pitfalls – & How to Avoid Them
- Lessons from IRS Exam Activity
- ACE Act Changes – How to Prepare (& Do We Need To?)
- Closing Thoughts

“

It’s not just about being able to write a check. It’s being able to touch somebody’s life”

– Oprah Winfrey

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Common Tax Pitfalls

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What Are the Common Risk Areas?

- Self-Dealing Transactions
- Excess Business Holdings
- Annual Income Distribution
- Taxable Expenditures
- Jeopardizing Investments
- Excise taxes & penalties can be severe – so understanding & avoiding is important

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Self-Dealing Transactions

- Specific Transactions with Disqualified Persons
  - Who is a Disqualified Person?
    - All Substantial Contributors
    - All Foundation Managers (Officers, Directors, or Trustees)
    - A >20% owner of an entity that was a substantial contributor to the foundation
    - A family member of any of the above
    - An entity owned 35% or more by any of the above

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Self-Dealing Transactions – What Are They?

- The Internal Revenue Code attempts to discourage certain behavior between a private foundation & its Disqualified Persons
- The rules against self-dealing are broad & far-reaching
- Generally prohibits any direct financial transactions between the Foundation & Disqualified Persons
- Also prohibit indirect financial/economic benefit to a Disqualified Person

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Self-Dealing Transactions – What Are They?

- Specific acts that are prohibited
  - Buying/selling property to or from a Disqualified Person (even on terms favorable to the Foundation)
  - Renting property to a Disqualified Person or leasing property from a Disqualified Person (other than on a rent-free basis)
  - Lending money or extending credit to a Disqualified Person or borrowing money from a Disqualified Person (exempt on an interest-free basis)
  - Paying excessive compensation to a Disqualified Person

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Self-Dealing Transactions – What Are They?

- Specific acts that are prohibited
  - Paying/reimbursing unreasonable expenses of a Disqualified Person
  - Allowing Disqualified Persons to use a foundation's income/assets/facilities (except for goods/services furnished on the same terms as the general public)
  - Satisfying the enforceable pledge of a Disqualified Person
  - Making payments to certain government officials

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Self-Dealing Transactions – Exceptions

- Paying reasonable compensation for necessary services
  - Services must be personal
- Reimbursement of reasonable & necessary expenses
- Tickets to fundraising events
  - Board members can use if attendance is reasonable & necessary
  - Use of tickets by spouse/family members is self-dealing

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Self-Dealing Transactions – Penalties for Violation

- 5% initial tax on the self-dealer
- 2.5% initial tax on the Foundation Manager
- Correction is required – penalties can be applied for each year until correction takes place
- Second-tier tax = 200% of the amount involved
  - 50% not to exceed $10,000 for Foundation Managers

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“Wealth isn’t always measured in dollar signs. We each have time, talent, & creativity, all of which can be powerful forces for positive change. Share your blessings in whatever form they come & to whatever level you have been blessed”

– Jon Huntsman

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Excess Business Holdings

The rationale underlying the excess business holding rules can be summed up by the Joint Committee on Internal Revenue Taxation on the Tax Reform Act of 1969

"Those who wish to use a foundation's stock holdings to acquire or retain business control in some cases were relatively unconcerned about producing income to be used by the foundation for charitable purposes. In fact, they may have become so interested in making a success of their business, or in meeting the competition, that most of their attention & interest was devoted to this with a result that what was supposed to be their function, that of carrying on charitable, educational, etc., activities was neglected"

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Business Enterprise

- Business Enterprise is broadly defined to include the active conduct of a trade or business, including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services, & that constitutes an unrelated trade or business
- Business enterprise does not include
  - A functionally related business
  - A Program Related Investment
  - A trade/business that derives at least 95% of its gross income from passive sources

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Excess Business Holdings

Permitted Holdings

- 2% De Minimis Rule: A private foundation is not treated as having EBH in any corporation if it owns (together with certain other related private foundations) not more than 2% in value of all outstanding shares of all classes of stock
- 20% of voting stock reduced by % of voting stock held by disqualified persons
  - If no disqualified person has effective control of the corporation, private foundations & disqualified persons together may instead own 35% of voting stock
  - If EBH is disposed of within 90 days from the date it's known to be EBH, it will be disregarded from calculation of EBH

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Holding Period

- A private foundation & its disqualified persons generally have five years to dispose of excess business holdings received via gratuitous transfers. Otherwise, a private foundation & its disqualified persons must dispose of excess business holdings within 90 days from the date on which the parties first know or have reason to know of the excess business holdings
- Failure to dispose of the excess business holdings within the aforementioned periods will trigger an excise tax equal to 10% of the excess business holdings

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Annual Income Distribution

- Private foundations are required to distribute a certain amount of funds for charitable purposes, including grants
- The distributable amount is equal to 5% of the combined FMV of the foundation assets
  - The distributable amount is reduced by any income taxes/excise tax on investment income
- Excess distributions may be carried forward for 5 years
- Failure to pay the distributable amount in a timely manner is subject to a 30% excise tax under IRC 4942

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Taxable Expenditures – Definition

- Taxable expenditures are any amounts paid or incurred to
  - Influence legislation or carry on propaganda
  - Influence a public election/voter registration drive (subject to exceptions)
  - Grants to an individual for travel, study, or similar purpose unless requirements are met
  - Grants to a non-501(c)3 public charity unless expenditure responsibility rules are followed
  - Carry out a non-exempt purpose

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Taxable Expenditures

- Taxable expenditures are subject to excise taxes
  - Taxes are imposed on the Foundation as well as any Foundation Manager who knowingly & willfully agrees to the expenditure
- Initial tax is 20% of the amount expended
- Second-tier tax is an additional 100%
- A 2.5% tax is imposed on a Foundation Manager who knowingly agreed to the expenditure
- A 50% tax is imposed on a Foundation Manager who refuses to correct the expenditure
- Taxes apply until the expenditure is corrected

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Jeopardizing Investments

- Foundation Managers have a fiduciary responsibility to act on behalf of the foundation's best interest
- Purpose is to shield the foundation assets from a high degree of risk, so to maximize both capital & income available for charitable purposes
- Prudent Investor Rule – return on investment is related to risk, that risk includes risk on deterioration of real return owing to inflation, & that the risk/return relationship must be taken into account in managing trust assets

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Jeopardizing Investments

- Jeopardizing investments generally show a lack of reasonable business care & prudence in providing for the short- & long-term financial needs of the foundation for it to carry out its exempt function. Some examples may include
  - Trading in securities on margin or commodity futures
  - Investing in working interests in oil & gas wells
  - Buying puts, calls, & straddles
  - Buying warrants or selling short

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Jeopardizing Investments

- Exceptions to jeopardizing investments include
  - Program-related investments
    - Investments that satisfy the following
      - Primary purpose is to accomplish exempt purposes
      - Production of income or appreciation of property is not a significant purpose
      - Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose
    - Examples may include low-interest loans to needy students, high-risk investments in nonprofit low-income housing projects, & investments in nonprofit organizations combating community deterioration

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Philanthropy is not about the money. It’s about using whatever resources you have at your fingertips & applying them to improving the world”

– Melinda Gates

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Lessons from IRS Exam Activity

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Foundation Audit Lessons

- How are audits initiated?
  - Data-driving audit approach
- What is the IRS looking for?
  - Significant changes in financial activity, *e.g.*, appearance of large loan on the balance sheet
  - Compensation vs. independent contractor payments
  - Expense reimbursements
  - Expenditure responsibility grants

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Foundation Audit Lessons

- Best practices to adopt
  - Periodically review/update Disqualified Person listing
  - Adopt conflict of interest policies & require annual disclosure
  - Adopt a travel policy
  - Adopt a fundraising event policy – who can use tickets?
  - Provider regular training to board/staff, especially after role transition
  - Adopting an investment policy statement

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ACE Act & Other Legislative Changes

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The Significance of DAFs

DAFs have become a substantial tool for charitable giving by individuals & other donors, as well as by private foundations

- There were approximately 1,005,000 DAFs in 2020
- Research conducted by the National Philanthropic Trust after reviewing data from 976 sponsors of DAFs for 2020 concluded
  - DAFs contributed almost $35 Billion in 2020 to operating charities
  - Contributions to DAFs equaled approximately $48 Billion in 2020

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The Pending Legislation – ACE ACT

- Senators Angus King (I-ME) & Chuck Grassley (R-IA) introduced legislation (S.1981) in 2021 called the Accelerating Charitable Efforts ("ACE") Act with the goal of limiting certain actions of DAFs & Private Foundations

The Rationale for Limiting a DAF’s Life

- The ACE Act intentionally creates a distinction between “working charities” & “non-working” charities
- The intention of the ACE Act is to discourage a perpetual endowment by limiting the favorable tax & operational advantages of DAFs compared to “working charities”

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Focus on DAFs

On November 4, 2022, the Office of Tax Policy & the IRS issued their 2022-2023 priority guidance plan

- Regulations under §4966 regarding donor-advised funds, including excise taxes on sponsoring organizations & fund management
- Regulations under §4967 regarding prohibited benefits, including excise taxes on donors, donor advisors, related persons, & fund management
- Regulations under §4958 regarding donor-advised funds & supporting organizations
- Guidance regarding the public-support computation with respect to distributions from donor-advised funds

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ACE Act – Private Foundation Proposals

- Minimum Distribution Requirement – certain expenses disallowed
  - Administrative Expenses paid to a “disqualified person” including family members & substantial contributors
  - Distributions to DAFs not considered qualifying distributions
- Excise tax calculation – no excise tax due for
  - Foundations paying out 7% or more
  - Foundations with sunset of 25 years or less
- Gifts to DAFs require more detailed disclosure on Form 990-PF

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“

You want to be the pebble in the pond that creates the ripple for change”

– Tim Cook

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