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# CHAPTER ONE

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## Introduction to Private Foundations

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### §1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

There are well in excess of one million tax-exempt charitable organizations in the United States, yet only about 75,000 of them are classified, for federal tax purposes, as private foundations. This fact alone—this isolation of foundations purely for purposes of government regulation—makes private foundations unique.

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

Certainly the regulatory regime imposed on private foundations is unique. There is no category of tax-exempt organization that is subject to anything like the compliance burdens that comprise the sweep of Chapter 42 of the Internal Revenue Code. Even the origin of this legislation is unique: The mood of Congress during the course of its endeavors in this regard in the years leading up to the 1969 legislation was very anti-private foundation, with the nation's legislature dismayed at the findings

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

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presented to it by the Department of the Treasury in a 1965 report and by a series of congressional hearings.<sup>2</sup> The animosity, sometimes hostility, against private foundations that motivated members of Congress and the staff at that time is reflected in the legislation that quickly took shape that year.

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

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

Sanctions for failure to comply with private foundation rules potentially include a tax (called the *Chapter 42 tax*) on both the foundation and its disqualified persons, loss of tax exemption, and repayment of all tax benefits accrued during the life of the foundation for its funders and itself. Under certain circumstances, these taxes can be abated if the violation was due to reasonable cause, rather than for willful and intentional reasons, and if the violation is properly corrected.<sup>3</sup>

An abstract of the private foundation tax rules is provided in Exhibit 1.1 to serve as a guide to those planning to create a private foundation as well as those seeking to briefly review the rules applicable to private foundations. Use of this guide and those found throughout the book, particularly the compliance checklists, can aid foundation managers and their advisors who seek to maintain the foundation's tax-exempt status and avoid sanctions.

Notwithstanding the turbulence within their legal setting, private foundations are a viable and valuable type of nonprofit organization. They are also unique in that they are often used as a means to accomplish the personal philanthropic goals of individuals. Some professional advisors discourage the formation of private foundations because of the complexity of the regulatory rules underlying and surrounding them. There is no question that the foundation rules are often more complicated than those applicable to public charities and other forms of exempt organizations. Nevertheless, the creation and operation of a private foundation can be a rewarding experience.

Private foundations are ideal charitable vehicles for many funders. One individual can create a foundation and be its sole trustee or director, and the entity can qualify for tax exemption. Commonly, a donor and his or her family members comprise the governing board of a private foundation. Absolute control of the organization by

2. See *infra* text accompanied by notes 16 and 19.

3. IRC § 4962.

## § 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

### EXHIBIT 1.1 Brief Description of Federal Tax Rules Applicable to Private Foundations

A private foundation (PF) is given special treatment by the federal income tax law because it is usually funded by an individual, a family, or other small number of persons. Congress, in 1969, added provisions to the tax code to prevent the operation of a private foundation for the benefit of its creators and insiders. The rules, in a negative fashion, term those that fund and control the foundation *disqualified persons* (DP). The disqualified persons and the foundation can be subject to excise taxes if the rules contained in Chapter 42 of the Internal Revenue Code are violated. The rules are sometimes identified by the code section numbers, 4940 to 4946. This exhibit briefly describes those code sections. It is not intended to describe the rules in depth but only to provide enough information to enable readers to know when to ask a question.

#### SELF-DEALING—§ 4941

In 1969, Congress felt that private foundations were being used as pocketbooks for funds not necessarily available to a foundation's related parties from other sources, and set out to completely eliminate self-interested financial activity between a privately funded charity and its insiders. A foundation, as a general rule, is constrained from having any financial transactions with persons who create, control, and fund it. This prohibition applies even if the PF benefits from the transaction. As an extreme example, a PF cannot buy for \$1 an asset that is worth \$1 million from a DP.

As with many tax rules, some exceptions may apply. Though the specific transactions in the following list, which constitute prohibited self-dealing, forbid the use of property, the PF's creator can provide rent-free office space. Similarly, although payment of compensation is literally prohibited, director's fees and salaries can be paid so long as the amount is reasonable for the services rendered. If a prohibited self-dealing transaction occurs, the money must be returned and the insider is subject to a 10 percent excise tax. Directors or trustees who approved the transaction may also be penalized. (See Chapter 5.) The following specific transactions between a foundation and its disqualified persons are identified as self-dealing and forbidden by the code:

- Sale, exchange, or leasing of property between a PF and a DP.
- Lending of money or other extension of credit between a PF and a DP.
- Furnishing of goods, services, or facilities by a PF to a DP and vice versa.
- Payment of compensation/reimbursement of expenses by a PF to a DP.
- Transfer to, or use by, or for benefit of, a DP of any income or assets belonging to a PF.
- Agreement by a PF to pay a government official.

#### MINIMUM DISTRIBUTION REQUIREMENT—§ 4942

A foundation must annually spend a minimum amount for grants, administrative, and other charitable disbursements. The required amount of the charitable payments, called *qualifying distributions*, is an amount equal to 5 percent of the average fair market value of the PF's investment assets for the preceding year. A PF in its first year of existence does not have a distribution requirement. Assume, for simplicity, that a foundation's investments have an average value of \$1 million during year 1. Its mandatory distribution amount for year 2 is \$50,000, payable before the end of year 2. In each succeeding year of its existence, the foundation must continue to distribute the mandatory amount based on the prior year's asset value. If charitable disbursements in a year exceed the required amount, the excess can be carried over five years to offset the mandatory amount in succeeding years. (See Chapter 6.)

(Continued)

## INTRODUCTION TO PRIVATE FOUNDATIONS

### EXHIBIT 1.1 (Continued)

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#### EXCESS BUSINESS HOLDINGS—§ 4943

A private foundation, when its ownership in a corporation or partnership is combined with the holdings of its disqualified persons, generally cannot own more than 20% of the total shares of that enterprise, unless the PF itself owns not more than 2 percent. A foundation cannot operate its own business or be what is called a *sole proprietor* of a business. If a foundation receives a donation of property that creates an excess business holding, the private foundation is allowed five years in which to dispose of the excess amount. (See Chapter 7.)

#### JEOPARDIZING INVESTMENT—§ 4944

A private foundation's directors and trustees must exercise prudence and good business judgment in investing the foundation's assets. They and the PF are penalized if any amount is invested in a manner that jeopardizes the PF's ability to carry out its tax-exempt purposes. This rule parallels state laws under which the managers of a PF have a fiduciary responsibility to safeguard its assets on behalf of its charitable constituents. The long- and short-term financial needs of the PF can be taken into account in evaluating the inherent risk of an investment, in accord with the Institutional Investor Act adopted by many states. The *Prudent Investor Rules* outlined by the American Bar Association in its *Restatement of the Law Trust Series* contain guidance on this subject. (See Chapter 8.)

#### TAXABLE EXPENDITURES—§ 4945

A private foundation must devote its income and principle exclusively to the charitable purposes for which it was created, and maintain records that prove its disbursements accomplish a charitable purpose. Payments made for noncharitable purposes and those without suitable documentation are called *taxable expenditures* and are subject to a 20 percent excise tax. Most PFs make grants to support the activities of churches, schools, hospitals, museums, and other public charities and can rely on the recipient's IRS status as proof of the charitable nature of the grant made. The Grants Checklist, Grant Agreement, and Grant Payment Transmittal found in § 9.5 can be used as a guide in gathering the appropriate documentation for such grants. It is important that the foundation ascertain, before it makes a grant, the public charity status of proposed grant recipients.

Although special documentation is required, a private foundation's support of another PF and individual scholarship and research grants can also serve its charitable purposes. A foundation that makes individual scholarship grants must seek advance approval for its program. A plan designed to assure that these grants are awarded on an objective and nondiscriminatory basis that allows no benefit to the foundation's insiders must be written. The issues involved and a sample letter for seeking approval can be found in Exhibit 2.2 and § 9.3. One foundation granting funds to another must enter into a contract with the other foundation, called an *expenditure responsibility agreement*, and make special reports to the IRS, also discussed in Chapter 9.

#### EXCISE TAX ON INVESTMENT INCOME—§ 4940 TAX

A private foundation must annually pay an excise tax on the income earned on its investments, including dividends, interest, royalties, rents, and capital gains from properties producing such income. The tax rate is 2 percent, but can be reduced to 1 percent in a year in which the PF's percentage of charitable expenditures in relation to its total assets increases. Some say that, essentially, the PF can choose to give away half of the tax to grantees rather than to the government.

To illustrate: If a PF receives net investment income of \$100,000, the foundation would owe a tax of \$2,000 (2 percent of the income). This excise tax is paid with tax deposit vouchers at a federal bank throughout the year on a quarterly basis, following the similar system for paying the estimated income tax. (See Chapter 10.) This tax is calculated on the Form 990-PF, which all PFs are required to file annually. (See Exhibit 12.1.)

## § 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS

### EXHIBIT 1.1 (Continued)

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#### RECORD-KEEPING SUGGESTIONS

##### GRANT DOCUMENTATION

A private foundation should maintain a permanent file for each of its grant recipients. At a minimum, a grant application should be required for each potential grantee and the Grants Checklist in Exhibit 9.2 should be completed prior to the issuance of any grant payment. Due to the specific rules governing its charitable expenditures and the paperwork involved in the grant-making process, a PF must carefully describe its charitable mission and the specific types of programs it supports. Even if the foundation's charter contains a broad charitable purpose, its grant decision makers may find it useful to narrow the categories of programs it supports. Some PFs develop written grant guidelines to inform interested persons of the purposes for which the foundation will grant funds. Many now publish their grant applications on a Website. It is important that the information entered in Part XV of Form 990-PF (see Exhibit 12.1) be accurate, because it is published nationwide in printed and electronic directories for grant seekers and on [www.guidestar.org](http://www.guidestar.org).

Many PFs ask whether they are required to keep the paperwork regarding grants that are not awarded. For federal tax purposes, there is no such requirement, but some foundations find it useful to keep these requests for a few years (in alphabetical order) for reference in the event the organization reapplies or someone inquires about the grant deliberation process.

##### DONATION ACKNOWLEDGMENT

Just like other charitable organizations, a PF must provide the type of receipt shown in Exhibit 12.7 to its contributors to acknowledge their donation and reveal whether or not any goods or services of value were provided in connection with the donation(s). The furnishing of goods or services may constitute prohibited self-dealing, as discussed in Chapter 5.

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its founder and family members is permitted, although financial and other transactions between them and the foundation are tightly constrained by the tax law.

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

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

Finally, a private foundation can serve as an ideal income and estate planning device for individuals with charitable interests. The classic example is a philanthropist who has publicly traded stock that is highly appreciated in value. A private foundation can be created, the securities contributed to the foundation and sold by that entity, and the philanthropist claims a charitable contribution deduction based on the full fair market value of the stock and avoids taxation of the capital gain.<sup>4</sup>

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

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The foundation can retain the stock and endeavor to expand its base of principal, and essentially spend only the income from its investments for its charitable purposes.

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

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

Philanthropists seeking to avoid the constraints applicable to private foundations should explore the pros and cons of establishing a supporting organization or a donor-advised fund.<sup>5</sup>

### §1.2 DEFINITION OF PRIVATE FOUNDATION

The federal tax law defines the term *private foundation* as a domestic or foreign charitable organization, other than one of the entities collectively known as *public charities*.<sup>6</sup> Thus, one way to view a private foundation is as a charitable organization<sup>7</sup> that cannot or does not qualify as a form of public charity.

Each U.S. and foreign charitable organization is presumed to be a private foundation; this presumption is rebutted by a showing that the entity is a church, school, hospital, medical research organization, publicly supported charity, a supporting organization, or an organization that tests for public safety.<sup>8</sup> That is, by operation of law, if a charitable organization cannot be classified as a public charity, it is (or becomes) a private foundation.<sup>9</sup>

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

5. See Chapter 16.

6. IRC § 509(a). The details of this definition are the subject of Chapter 15.

7. That is, an organization that is tax-exempt pursuant to IRC § 501(a) as an organization described in IRC § 501(c)(3).

8. IRC § 509(a)(1)–(4).

9. IRC § 508(b).

### § 1.3 HISTORY AND BACKGROUND

is actually one of what a private foundation *is not*, rather than a definition of what a private foundation *is*.)

If circumstances change, or if its creators wish it, a private foundation can terminate its private foundation status. This happens most frequently where the organization's level or mix of funding is such that it can qualify as a publicly supported charity or where the organization converts to a supporting organization. A private foundation can distribute all of its assets to a public charity and dissolve itself or can merge into one or more other private foundations.<sup>10</sup>

### § 1.3 HISTORY AND BACKGROUND

Private foundations have long been much-maligned entities, not only in the federal tax laws but within society at large. Their history, which is extensive, is rich with many successes and strewn with few abuses.<sup>11</sup> They are vehicles for some of the most humanitarian and progressive acts, yet whenever a list of tax "reforms" is compiled, private foundations, and/or the tax law rules that apply to them, always seem to attract much attention.

A private foundation is a unique breed of tax-exempt organization, in that while it is recognized as charitable, educational, or the like, it is usually controlled and supported by a single source, for example, one donor, a family, a company. This one characteristic, which the Internal Revenue Service (IRS) has recognized as an indirect but nonetheless qualifying means of support of charity,<sup>12</sup> spawns several criticisms, including alleged irresponsible governance and inadequate responses to perceived needs. Private foundations are similarly chastised for being elitist, playthings of the wealthy, and havens for "do-gooders" assuaging their inner needs by dispensing beneficence to others.<sup>13</sup>

More serious criticisms of private foundations are that they further various tax inequities, are created for private rather than philanthropic purposes, and do not actually achieve charitable ends.<sup>14</sup> As will be developed in subsequent chapters, nearly all of the abuses—perceived or otherwise—involving private foundations were eradicated as the result of enactment of the Tax Reform Act of 1969.<sup>15</sup>

The origins of private foundations are traceable to the genesis of philanthropy itself. Foundations as legal entities were recognized in the Anglo-Saxon legal system and were fostered in the United States by the law of charitable trusts. Charitable endowments in America are essentially creatures of common law, although amply sustained in statutory laws concerning taxes, corporations, decedents' estates, trusts, and property.<sup>16</sup> The modern American foundation is of relatively recent vintage,

10. See Chapter 13.

11. Wormser, *Foundations: Their Power and Influence* (Sevierville, TN: Catholic House Books, 1993); Andrews, *Philanthropic Foundations* (New York: Russell Sage Foundation, 1956).

12. IRS Revenue Ruling (Rev. Rul.) 67-149, 1967-1 C.B. 133.

13. E.g., Branch, "The Case Against Foundations," *The Washington Monthly* 3 (July 1971).

14. E.g., Stern, *The Great Treasury Raid* 242-246, (New York: Random House, 1964). Cf. Stern, *The Rape of the Taxpayer* (New York: Random House, 1973).

15. As one court stated, Congress enacted these rules "to put an end, as far as it reasonably could, to the abuses and potential abuses associated with private foundations" (*Mannheimer Charitable Trust, Hans S. v. Commissioner*, 93 T.C. 35, 39 (1989)).

16. Fremont-Smith, *Foundations and Government* (New York: Russell Sage Foundation, 1965), especially Chapter 1.

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dating back to the mid-nineteenth century. Many of the well-known foundations are reflective of the great fortunes established at the advent of the 1900s. Foundations proliferated after World War II, in large part because of favorable economic conditions and tax incentives. More recently, private foundations founded and funded by those successful in the realm of technology are being added to the list of the nation's largest charities.

Foundations were not defined (albeit indirectly) in the Internal Revenue Code (nor in any other federal statute) until 1969—though not because of lack of interest in them by Congress. They were investigated, for example, by the “Walsh Committee” (the Senate Industrial Relations Committee) from 1913 to 1915 for allegedly large stockholdings, by the “Cox Committee” (House Select Committee to Investigate and Study Educational and Philanthropic Foundations) in 1952, by Representative B. Carroll Reece in 1954 (the House Special Committee to Investigate Tax-Exempt Foundations and Comparable Organizations) for alleged support of subversives, and by Representative Wright Patman throughout the 1960s for allegedly tending more to private interests than public benefit. Congressman Patman's inquiries and others' culminated in the extensive foundation provisions of the Tax Reform Act of 1969,<sup>17</sup> which introduced the first statutory definition of the term *private foundation*. Yet a more expressive definition is: “. . . a nongovernmental, nonprofit organization, with funds and program managed by its own trustees or directors, and established to maintain or aid social, educational, charitable, religious, or other activities serving the common welfare.”<sup>18</sup>

Controversy persists over the appropriate role for foundations in America—or whether they should exist at all. Foundations are attacked by some as too uninvolved in current issues and problems and by others as too effective in fomenting social change.<sup>19</sup> The federal government is now spending billions of dollars in the realms of health, education, and welfare, formerly the preserves of private philanthropy. Recent years have also borne witness to intensified drives for tax “reform,” tax “equality,” and tax “simplification.” These and other developments have made the tax treatment for private foundations and their donors even more vulnerable.

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

Private philanthropy plays a special vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly.

17. Andrews, *Patman and Foundations: Review and Assessment* (New York: Foundation Center, 1968); Myers, “Foundations and Tax Legislation,” VI Bull. of Found. Lib. Center (No. 3) 51 (1965). Following a preliminary survey in 1961, Rep. Patman caused publication of “Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy,” Chairman's Report to (House) Select Committee on Small Business, First Installment, 87th Cong., 1st Sess. (1962). Six additional installments were published over the period 1963 to 1968.

18. The Foundation Center, *The Foundation Directory*, 4th ed. (1971), vii.

19. E.g., Miller, “Are Foundations an Endangered Species?” *Reader's Digest* 191 (July 1974); Yarmolinsky, “The Foundation as an Expression of the Democratic Society,” 5 *N.Y.U. Conf. on Char. Fdns.* 65 (1961).

### § 1.3 HISTORY AND BACKGROUND

Private foundations have an important part in this work. Available even to those of relatively restricted means, they enable individuals or small groups to establish new charitable endeavors and to express their own bents, concerns, and experience. In doing so, they enrich the pluralism of our social order. Equally important, because their funds are frequently free of commitment to specific operating programs, they can shift the focus of their interest and their financial support from one charitable area to another. They can, hence, constitute a powerful instrument for evolution, growth, and improvement in the shape and direction of charity.<sup>20</sup>

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

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

Private foundations today number, as noted, about 75,000 charitable organizations. With community foundations included, it has been estimated that foundation grant-making in 2006 totaled \$36.5 billion, accounting for 12.4 percent of total estimated charitable giving for that year. This amount of grant-making constituted a 12.6 percent increase in private foundation funding (9.1 percent adjusted for inflation) compared with the final amount of \$32.41 billion in foundation grant-making in 2005. Grant-making by private foundations has increased an average of 4.4 percent annually since 1966 (adjusted for inflation), with the annual increase in this type of funding in the past 10 years averaging 9.3 percent (notwithstanding the fact that there was no growth of this nature in 2002 and 2003).<sup>22</sup>

A report observed that an “increasing number of donors are creating funds and foundations as a vehicle for making gifts,”<sup>23</sup> stating that from 2001 to 2005 the number of family foundations rose from 27,804 to 33,994 (a rate of growth of 22.3 percent). All independent foundations (including family foundations) increased from 55,120 in 2001 to 63,059 in 2005 (a growth rate of 14.4 percent). In 2001, family foundations constituted 50 percent of the independent foundations; in 2005, this percentage was 55 percent.<sup>24</sup>

20. *Treasury Department Report on Private Foundations*, Committee on Finance, United States Senate, 89th Cong., 1st Sess. (1965), 5 (also 11–13).

21. Council on Foundations, *Report and Recommendations to the Commission on Private Philanthropy and Public Needs on Private Philanthropic Foundations* 1–8 (1974).

22. *Giving USA 2007*, 93 (Giving USA Foundation, 2007).

23. *Id.* at 95. The reference to funds is to donor-advised funds (see Chapter 16).

24. *Giving USA 2007*, 95 (Giving USA Foundation, 2007).

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In 2005, one-half of family foundations granted less than \$50,000 each. Approximately 6 percent of family foundations reported grant-making of at least \$1 million for 2005; the remaining 44 percent of the other half of family foundations made grants between \$50,000 and \$1 million, with most of the entities in that group granting between \$100,000 and \$500,000. In general, it was reported, family foundations “were more likely than independent foundations overall to make grants for education, health, the environment (including animal protection), and religion.”<sup>25</sup> Foundation funding in 2005 was allocated as follows: education (23.9 percent), health (22.2 percent), public-society benefit (14.3 percent), human services (14.2 percent), arts (12.4 percent), environment and animals (6.8 percent), international affairs and development (3.5 percent), and religion (2.6 percent).<sup>26</sup>

According to one source, the “principal factors driving growth in foundation giving in 2006 were strong gains in the stock market and a higher level of new foundation establishment that was seen in the early 2000s.”<sup>27</sup> More specifically, the following trends were seen as important to private foundation grant-making in 2006: (1) unexpectedly strong growth in assets; (2) faster rate of establishment of private foundations and of new giving to foundations (with a 35 percent increase in such giving between 2004 and 2005); (3) higher levels in grant-making than required by the payout rules,<sup>28</sup> in part because of the number of relatively new foundations that function as pass-through vehicles for giving by donors during their life; and (4) various private operating foundations<sup>29</sup> created by pharmaceutical companies that distributed more than \$3 billion in fair-market value of medicines and other products to needy patients.<sup>30</sup>

In general, the future for private foundations remains bright. The great regulatory surge that swept over them (and swept many of them away) has moved on to other types of nonprofit organizations. The federal income tax laws, while complex, are conducive to the establishment and operation of private foundations. Nonetheless, as subsequent chapters demonstrate and as the U.S. Tax Court observed, “classification as a private foundation is burdensome.”<sup>31</sup>

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25. *Id.*

26. *Id.* at 96.

27. *Id.* at 93 (quotation from the Foundation Center).

28. See Chapter 6.

29. See § 3.1.

30. *Giving USA 2007*, 93 (Giving USA Foundation, 2007). This compilation of statistics does not include grant-making from private foundations related to business corporations (about \$4.2 billion in 2006) (although the annual summaries assembled by the Foundation Center do), yet includes grant-making by community foundations (which are public charities (see § 15.4(d)). Moreover, grant-making from donor-advised funds (see Chapter 16) that are within community foundations is included in these private foundation grant-making estimates, yet grant-making from “commercially sponsored” donor-advised funds and such funds within public charities (other than community foundations) are not.

31. *Friends of the Society of Servants of God v. Commissioner*, 75 T.C. 209, 212 (1980). Most of the contemporary professional literature concerning private foundations is devoted to the technicalities of the private foundation rules. In the aftermath of enactment of these rules, however, there were many articles exploring these rules in general and musing on the future of private foundations because of them. These articles include McCue III and Gallanis, “Charitable Foundations: What We Have Learned In 20 Years,” 131 *Trusts & Estates* 12 (Aug. 1992); Rosen and Saper, “A Private Foundation Adds Flexibility to an Individual’s Planned Charitable Giving,” 16 *Estate Planning* (No. 1) 16 (1989); Ward, “Private Foundations: A Summary for the General Practitioner,” 52 *Tex. Bar Jour.* (No. 5) 527 (1989); McCoy, “Private Foundations and Related Entities in the Post-Tax Reform Era,” 21 *Univ. of Miami Philip E. Heckler Institute on Estate Planning*

## § 1.4 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT

### § 1.4 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT

Within the realm of tax-exempt organizations, there are relatively few private foundations; they account for about 5 percent of exempt organizations.<sup>32</sup>

Nearly all tax-exempt organizations are identified as such by federal statute.<sup>33</sup> Some, mostly governmental entities, are exempt in accordance with a constitutional law doctrine, such as the doctrine of intergovernmental immunity.

10 (1989); Edie, "How to Set Up a Private Foundation," 125 *Trusts & Estates* (No. 8) 38 (1986); Webster, "Private Foundations Now Even More Attractive for Charitable-minded Client," 14 *Tax. for Lawyers* (No. 5) 280 (1986); Clymer, "The Private Foundation: A New Marketing Opportunity?" 125 *Trusts & Estates* (No. 8) 31 (1986); Gilbert and Waldman, "Despite Complexity, Private Foundations Offer Advantages to Donors with Charitable Intentions," 12 *Estate Planning* (No. 4) 212 (1985); Sugarman, "New Incentives and Choices for Charitable Gifts to Private Foundations," 9 *Rev. of Tax. of Indivs.* (No. 3) 219 (1985); Neely, "The Private Foundation Rules: Impact of the Tax Reform Act of 1984," 63 *Taxes* (No. 4) 251 (1985); Turkel, "Current Developments in Private Foundations—Selected Issues," 42 *N. Y. Univ. Inst. on Fed. Tax.* 29 (1984); Southeastern Council of Foundations, *Why Establish a Private Foundation?* (1980); Pekkanen, "The Great Givers: Inside America's Top Foundations," (Part I) 133 *Town & Country* (No. 4996) 141 (Dec. 1979), (Part II) 134 *Town & Country* (No. 4997) 37 (Jan. 1980); Russell, *Giving and Taking: Across the Foundation Desk* (1977); Nason, *Trustees and the Future of Foundations* (1977); Lloyd, "Private Foundations Still a Useful Tool Despite Their Potential for Being Taxed," 3 *Estate Planning* 106 (1976); Iadarola and Brown, "The Private Foundation: Still Viable in the Post-1969 Era," *National Public Accountant* 20 (No. 2) 28 (1975); Kennedy, "Financial Problems of Foundations Today," 12 *N.Y.U. Conf. on Char. Fdns.* 15 (1975); Stone, "The Charitable Foundation: Its Governance," 39 *Law and Contemporary Problems* 57 (1975); Worthy, "The Tax Reform Act of 1969: Consequences for Private Foundations," 39 *Law and Contemporary Problems* 232 (1975); Wadsworth, "Private Foundations and the Tax Reform Act of 1969," 39 *Law and Contemporary Problems* 255 (1975); *Tax Information for Private Foundations and Foundation Managers*, IRS Pub. 578; Smith and Chiechi, *Private Foundations: Before and After the Tax Reform Act of 1969* (1974); Hale, "How Firm a Foundation?" 60 *A.B.A.J.* 85 (1974); Bandy, "Survey of Foundation Advisors and Foundation Managers," 51 *Taxes* 4 (1973); Wagner, "Private Foundations Still Have a Place in Planning to Save Taxes," 2 *Tax. for Lawyers* 38 (1973); Heimann (ed.), *The Future of Foundations* (1973); Nielsen, *The Big Foundations* (1972); Guthery, "New Private Foundation Provisions," 58 *A.B.A.J.* 70 (1972); Hochberg and Stein, "Private Foundations: A Tour Through the Labyrinth Created by the '69 Act," 37 *J. Tax.* 49 (1972); Hochberg and Stein, "Classification as a Private Foundation Has Many Tax Ramifications," 37 *J. Tax.* 88 (1972); Lehrfeld, "Private Foundations in Post-1969 Era: Have Controls Spawned New Trend to Orthodoxy?" 36 *J. Tax.* 292 (1972); Moore, "Private Foundations—Their Present Tax Status," 7 *Real Prop. Prob. & Tr. J.*[cf1] 552 (1972); DeWind and Luey, "Some of the Things You Always Wanted to Know About Private Foundations," 24 *Tax Lawyer* (No. 3) 551 (1971); Weithorn (ed.), *Private Charitable Foundations* (1971); Note, "Private Foundations and the 1969 Tax Reform Act," 7 *Col. J. of Law and Soc. Prob.* 240 (1971); Hauser, "How Infirm a Foundation," 49 *Taxes* 750 (1971); Thrower, "Future of the Private Foundation—A Tax Analysis," 110 *Trust & Estates* 824 (1971); Grants, "Is the Small Foundation Viable?" 20 *N.Y.U. Conf. on Char. Fdns.* 273 (1971). Goldstein and Sharpe, "Private Charitable Foundations After Tax Reform," 56 *A.B.A.J.* 447 (1970); Lehrfeld, Liles, and Middleditch, "Private Foundations," 23 *Tax Lawyer* 435(1970); Eliasburg, "New Law Threatens Private Foundations: An Analysis of the New Restrictions," 32 *J. Tax.* 156 (1970); Eliasberg, "Tax Reform and Section 501(c)(3)—The Private Foundation Goes Public," 4 *J. Bev. Hills Bar Assn.* (No. 2) 27 (1970); Kahn, "Regulation of Privately Supported Foundations—Some Anomalies," 4 *Indiana L. Rev.* 271 (1970); Backus, "The Private Foundation Faces the Tax Reform Act of 1969—What to Do," 16 *Prac. Lawyer* (No. 6) 13 (1970).

32. See § 1.3.

33. Most categories of tax-exempt organizations are the subject of IRC § 501(c). Other types of exempt organizations are referenced in IRC §§ 526–529.

## INTRODUCTION TO PRIVATE FOUNDATIONS

Of those tax-exempt organizations that have a statutory authorization, more than 50 percent are *charitable* in nature.<sup>34</sup> The term *charitable* encompasses entities that are “charitable” in a technical sense as well as those that qualify as educational, religious, scientific, and like entities. Each of these types of entities is defined in the federal tax law.<sup>35</sup>

There are, however, many additional types of tax-exempt organizations other than those that are charitable in nature. Other exempt organizations (often ones that private foundations will encounter) include title-holding corporations,<sup>36</sup> social welfare organizations,<sup>37</sup> labor organizations,<sup>38</sup> business and professional associations,<sup>39</sup> social clubs,<sup>40</sup> fraternal organizations,<sup>41</sup> veteran’s organizations,<sup>42</sup> and political organizations.<sup>43</sup>

### § 1.5 DEFINITION OF CHARITY

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

The federal tax law definition of the term *charitable* is based on English common law and trust law precepts. Federal income tax regulations recognize this fact by stating that the term is used in its “generally accepted legal sense.”<sup>44</sup> At the same time, court decisions continue to expand the concept of *charity* by introducing additional (more contemporary) applications of the term. As one court observed, evolutions in the definition of the word *charitable* are “wrought by changes in moral and ethical precepts generally held, or by changes in relative values assigned to different and sometimes competing and even conflicting interests of society.”<sup>45</sup>

The term *charitable* in the federal income tax setting, in the more technical sense, embraces a variety of purposes and activities. These include relief of the poor and distressed or of the underprivileged, the advancement of religion, advancement of education, advancement of science, lessening of the burdens of government,

34. That is, are tax-exempt organizations described in IRC § 501(c)(3).

35. See § 1.5.

36. That is, entities described in IRC § 501(c)(2) and (25). See *Tax-Exempt Organizations* § 19.2 and *Tax Planning and Compliance*, chapter 10.

37. That is, entities described in IRC § 501(c)(4). See *Tax-Exempt Organizations*, Chapter 13, and *Tax Planning and Compliance*, Chapter 6.

38. That is, entities described in IRC § 501(c)(5). See *Tax-Exempt Organizations* § 16.1 and *Tax Planning and Compliance*, Chapter 7.

39. That is, entities described in IRC § 501(c)(6). See *Tax-Exempt Organizations*, Chapter 14, and *Tax Planning and Compliance*, Chapter 8.

40. That is, entities described in IRC § 501(c)(7). See *Tax-Exempt Organizations*, Chapter 15, and *Tax Planning and Compliance*, Chapter 9.

41. That is, entities described in IRC § 501(c)(8) and (10). See *Tax-Exempt Organizations* § 19.4.

42. That is, organizations described in IRC § 501(c)(19). See *Tax-Exempt Organizations* § 19.11.

43. That is, organizations described in IRC § 527. See *Tax-Exempt Organizations*, Chapter 17, and *Tax Planning and Compliance*, Chapter 23.

44. Income Tax Regulations (Reg.) § 1.501(c)(3)-1(d)(2).

45. *Green v. Connolly*, 330 F. Supp. 1150, 1159 (D.D.C. 1971), *aff’d sub nom. Coit v. Green*, 404 U.S. 997 (1971).

## § 1.6 OPERATING FOR CHARITABLE PURPOSES

community beautification and maintenance, promotion of health, promotion of social welfare, promotion of environmental conservancy, advancement of patriotism, care of orphans, maintenance of public confidence in the legal system, facilitating student and cultural exchanges, and promotion and advancement of amateur sports.<sup>46</sup>

*Charitable organizations*, as that term is used in the most encompassing manner, includes *educational organizations*. In addition to institutions such as schools, colleges, universities, museums, and libraries, educational organizations are those that (1) provide instruction or training of individuals in a variety of subjects for the purpose of improving or developing their capabilities or (2) instruct the public on subjects useful to the individual and beneficial to the community.<sup>47</sup>

*Religious organizations* are part of the community of charitable organizations. These entities are churches and other membership and nonmembership religious organizations. For reasons of constitutional law, the terms *religion* and *religious* cannot be accorded a definition applied by governmental agencies.<sup>48</sup>

*Scientific organizations* are, for the most part, those that engage in scientific research. Entities that are scientific in nature may have as their primary purpose the dissemination of scientific information by such means as publications and conferences. These organizations may also be considered educational in nature.<sup>49</sup>

## § 1.6 OPERATING FOR CHARITABLE PURPOSES

A private foundation, as is the case with all tax-exempt charitable organizations, must meet a standard for qualification as a charitable organization, referred to as the *operational test*. This test requires that the private foundation operate *exclusively* to accomplish one or more of the eight purposes referenced in the Internal Revenue Code: religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals.<sup>50</sup> The term *exclusively* for purposes of the organizational test does not literally mean exclusively, but rather means *primarily*.<sup>51</sup> Consequently, the conduct of some amount of nonexempt activity is permitted for organizations qualifying for tax exemption as charitable organizations. Due to the application of the private foundation sanctions,<sup>52</sup> however, a private foundation must operate only, or truly exclusively, for one or more of the named charitable purposes. The organizational test also requires that the organization's articles of organization provide that no part of the net earnings of the corporation, community chest, fund, or foundation inure to the benefit of any private shareholder or individual.<sup>53</sup> Simply stated, a private foundation may not operate to accomplish the private purposes or serve the private interests of its founders,

46. Reg. § 1.501(c)(3)-1(d)(2). See *Tax-Exempt Organizations*, Chapter 7, and *Tax Planning and Compliance*, Chapter 4.

47. Reg. § 1.501(c)(3)-1(d)(3). See *Tax-Exempt Organizations*, Chapter 8, and *Tax Planning and Compliance*, Chapter 5.

48. See *Tax-Exempt Organizations*, Chapter 10, and *Tax Planning and Compliance*, Chapter 3.

49. Reg. § 1.501(c)(3)-1(d)(5). See *Tax-Exempt Organizations*, Chapter 9.

50. See § 1.5.

51. Reg. § 1.501(c)(3)-1(d)(1)(ii).

52. See § 1.8.

53. See § 5.1.

## INTRODUCTION TO PRIVATE FOUNDATIONS

those who control it, those who fund it, or their families—these persons are termed *disqualified persons*.<sup>54</sup>

A qualifying private foundation promotes the general welfare of society. Evidence for satisfaction of this operational test is found not only in the nature of the nonprofit's activities but also in its sources of financial support, the constituency for whom it operates, and the nature of its expenditures. The presence of a single non-exempt program, if substantial in nature, will destroy the exemption regardless of the number or importance of the truly exempt purposes.<sup>55</sup>

The benefit to an individual participating in a foundation's programs is acceptable when the activity itself is considered a charitable pursuit. Examples of these benefits are the advancement a student receives from attending college and the relief from suffering experienced by a sick person. The standards of permissible individual benefit are different for certain of the eight categories of charitable purpose and the distinctions are sometimes vague and not necessarily logical. For example, promoting amateur sports competition is treated as an exempt purpose, but maintaining an athletic facility that restricts its availability to less than the entire community is not charitable.<sup>56</sup> A sports club serving only its individual members is not charitable,<sup>57</sup> but a fitness center promoting health and available to the general public may qualify as a charitable organization.<sup>58</sup> Visiting a museum or attending a play is recognized as educational, but attending a semiprofessional baseball game is not.<sup>59</sup>

To prove that its programs benefit the public, rather than private individuals, a private foundation often must be found to benefit an indefinite class of persons—a charitable class—rather than a particular individual or a limited group of individuals. It may not be "organized or operated for the benefit of private interests such as designated individuals, the creator's family, shareholders of the organization or persons controlled, directly or indirectly, by such private interests."<sup>60</sup> Thus, a trust established to benefit an impoverished retired minister and his wife cannot qualify.<sup>61</sup> Likewise, a fund established to raise money to finance a medical operation, rebuild a house destroyed by fire, or provide food for a particular person does not benefit a charitable class. An organization formed by merchants to relocate homeless persons from a downtown area was found to serve the merchant class and promote their interests,

54. See Chapter 4. A strange and troublesome opinion from the U.S. Tax Court was based on the operational test. On that occasion, the court held that an organization cannot qualify for tax-exempt status as a charitable or educational entity because its activities and those of its founder, sole director, and officer are essentially identical (*Salvation Navy, Inc. v. Commissioner*, 84 T.C.M. 506 (2002)). The court wrote that the affairs of the organization and this individual are "irretrievably intertwined," so that the "benefits" of tax exemption would "inure" to the individual personally (at 508). Many charities engage in activities that their founders would otherwise personally undertake and they are under the direct control of these individuals; this is typical of a private foundation.

55. *Better Business Bureau of Washington, D.C. v. United States*, 326 U.S. 279, 284 (1945).

56. Rev. Rul. 67-325, 1967-2 C.B. 113.

57. *I Media Sports League, Inc. v. Commissioner*, 52 T.C.M. 1092 (1986).

58. E.g., IRS Private Letter Ruling (Priv. Ltr. Rul.) 8935061. An important issue in these private rulings is whether fees charged limit the availability of the facility to the general public—a characteristic required to prove that the organization operates for charitable purposes.

59. *Hutchinson Baseball Enterprises, Inc. v. Commissioner*, 73 T.C. 144 (1979), *aff'd*, 696 F.2d 757 (10th Cir. 1982); *Wayne Baseball, Inc. v. Commissioner*, 78 T.C.M. 437 (1999).

60. Reg. § 1.501(c)(3)-1(d)(1)(iii).

61. *Carrie A. Maxwell Trust, Pasadena Methodist Foundation v. Commissioner*, 2 T.C.M. 905 (1943).

### § 1.6 OPERATING FOR CHARITABLE PURPOSES

rather than those of the homeless or the citizens.<sup>62</sup> In explaining the meaning of the word *charitable*, the regulations also deem federal, state, and local governments to be charitable entities by stipulating that relieving their burdens is a form of charitable activity qualifying for tax exemption.<sup>63</sup>

A comparatively small group of individuals can be benefited as long as the group is not limited to identifiable individuals. The class need not be indigent, poor, or distressed.<sup>64</sup> A scholarship fund for a college fraternity that provided school tuition for deserving members was ruled to be a tax-exempt foundation,<sup>65</sup> but a trust formed to aid destitute or disabled members of a particular college class was deemed to benefit a limited class. The “general law of charity recognizes that a narrowly defined class of beneficiaries will not cause a charitable trust to fail unless the trust’s purposes are personal, private or selfish as to lack the element of public usefulness.”<sup>66</sup> Criteria for selection of eligible beneficiaries should be followed, and evidence used to choose eligible individuals—case histories, grade reports, financial information, recommendations from specialists, and the like—should be maintained.

A genealogical society tracing the migrations to and within the United States of persons with a common name was found to qualify as a tax-exempt social club, rather than a charity. Although there was educational merit in the historical information compiled, the private interest of the family group was held to predominate.<sup>67</sup> If membership in the society is open to all and its focus is educational—presenting lectures, sponsoring exhibitions, publishing a geographic area’s pioneer history—it may be classified as charitable.<sup>68</sup> In contrast, a society limiting its membership to one family and compiling research data for family members individually cannot qualify for tax exemption.<sup>69</sup>

A simple way to prove that an organization operates to benefit a charitable class is for the organization to regrant its monies only to another public charitable organization. Congress imposed such a system on private foundations in 1969 to constrain their grant-making freedom, as described in the analysis of the expenditure responsibility rules.<sup>70</sup> Private foundations can grant monies to individuals and nonpublic entities for a charitable purpose, but only if they enter into a formal contractual agreement with the grant recipient or obtain IRS approval in advance for individual grant programs. Although there are no such formal rules for public charities, a similar burden to prove that grant funds reach a charitable class exists.

62. *Westward Ho v. Commissioner*, 63 T.C.M. 2617 (1992).

63. Reg. § 1.501(c)(3)-1(d)(2); see § 4.6 of *Tax Planning and Compliance* for discussion of standards for qualifying as “Lessening the Burdens of Government.” See also “How the Concept of Charity Has Evolved,” presentation for the American Bar Association Exempt Organization Committee, 16 *Exempt Org. Tax Rev.* (No. 3) 403–412 (Mar. 1997).

64. *Consumer Credit Counseling Service of Alabama, Inc. v. United States*, 78-2 U.S.T.C. ¶ 9468 (D.C.1979), but see *El Paso del Aquila Elderly v. Commissioner*, 64 T.C.M. 376 (1992) (making burial insurance available at cost for the elderly is a charitable activity only if distress is relieved (by allowing indigents to participate) and the community as a whole benefits).

65. Rev. Rul. 56-403, 1956-2 C.B. 307.

66. IRS General Counsel Memorandum (Gen. Couns. Mem.) 39876.

67. *Callaway Family Association, Inc. v. Commissioner*, 71 T.C. 340 (1978); Rev. Rul. 67-8, 1967-1 C.B. 142.

68. Rev. Rul. 80-301, 1980-2 C.B. 180.

69. Rev. Rul. 80-302, 1980-2 C.B. 182.

70. See Chapter 9.

## INTRODUCTION TO PRIVATE FOUNDATIONS

The IRS inserts the following language in the determination letters of grant-making public charities:

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

An organization's tax-exempt status was revoked because it failed to prove that its individual refugee relief payments were made to members of a charitable class. The IRS agreed to reinstate the exemption only if all payments were made directly to charitable organizations, governmental units, or organizations that would otherwise qualify as public charities (presumably foreign relief groups such as the World Health Organization or the United Nations Relief Agency).<sup>71</sup> Similarly, an organization lost its tax-exempt status for lack of evidence that it served a charitable class.<sup>72</sup> The organization operated canteen-style lunch trucks and argued that the food was provided to needy persons on a donation or "love offering basis." The evidence found lacking by the court included:

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

The some 9,000 current and former employees, volunteers, and families of an exempt healthcare provider were found by the IRS to be a sufficiently large class of beneficiaries to qualify as a charitable class. Gifts to the assistance fund created by the hospital were ruled deductible as charitable gifts because they were not earmarked for any specific person. The IRS also noted that the contributions were not made with the expectation of individual financial benefit, but instead were voluntary gifts to provide assistance to financially needy persons suffering economic hardship due to accident, loss, or disaster.<sup>73</sup>

The IRS, however, subsequently adopted a contrary position and reversed its ruling that a company foundation's disaster relief program was charitable.<sup>74</sup> Although there was some public benefit from the foundation's provisions of assistance in times of disaster or financial crisis, the IRS found no assurance that selection of beneficiaries

71. Revocation letter dated May 24, 1993, issued to the National Defense Council.

72. *New Faith, Inc. v. Commissioner*, 64 T.C.M. 1050 (1992).

73. Priv. Ltr. Rul. 9316051, modified and superseded by Priv. Ltr. Rul. 9741047 (with the IRS stressing the facts that the class of eligible beneficiaries is "sufficiently large and open-ended," and that beneficiaries are selected on an "objective and nondiscriminatory basis" designed to provide relief to those who are "needy and distressed").

74. Priv. Ltr. Rul. 199914040, revoking Priv. Ltr. Rul. 9516047.

## § 1.7 ORGANIZATIONAL RULES

solely among employees of a particular employer serves the best interests of the public. Instead, the foundation was deemed to serve “the private interests of X and its subsidiaries who utilize such benefit programs to recruit and retain a more stable and productive workforce.” Because the beneficiaries were a designated or limited group—employees of a specific company—they did not constitute a charitable class and the foundation could not qualify for a tax exemption. For the same reasons, the disbursements made by the foundation were taxable expenditures<sup>75</sup> of benefit to the company officials and owners. Because the benefit to the company was more than incidental and tenuous, the grants distributed by the foundation also resulted in acts of self-dealing.<sup>76</sup> Additionally, the expenditures did not constitute qualifying distributions<sup>77</sup> because they did not serve a charitable purpose.

A similar issue can arise in connection with a company foundation’s scholarship plan. To qualify as a charitable program, this type of plan must meet mathematical tests essentially designed to limit the probability of an employee’s qualification to assure that such foundations do not overly serve the private interests of an employer.<sup>78</sup>

## § 1.7 ORGANIZATIONAL RULES

One of the fundamental requirements in the law pertaining to tax-exempt organizations, particularly charitable ones, is that these organizations must be *organized* for one or more tax-exempt purposes. This is known as the *organizational test*.<sup>79</sup>

The organizational test for charitable organizations, in general, emphasizes two requirements. One focuses on the organization’s statement of purposes, requiring language that articulates a charitable end and forbidding language that may empower the organization to engage, to more than an insubstantial extent, in noncharitable activities or to pursue noncharitable purposes.<sup>80</sup> The other mandates a *dissolution clause*, which directs the passage of the organization’s assets and net income, in the event of its dissolution or liquidation, for charitable ends, usually by causing transfer of the assets and income to one or more other charitable organizations.<sup>81</sup>

There is, however, a separate and additional organizational test for private foundations. A private foundation cannot be exempt from federal income tax (nor will contributions to it be deductible as charitable gifts) unless its governing instrument or the provisions of state law applicable to it include provisions, the effects of which are to require distributions at such time and in such manner as to comply with the annual payout rules and prohibit the foundation from engaging in any act of self-dealing, retaining any excess business holdings, making any jeopardizing investments, or making any taxable expenditures.<sup>82</sup> Generally, these provisions must be in the foundation’s articles of organization<sup>83</sup> and not merely in its bylaws.<sup>84</sup>

75. See Chapter 9.

76. See § 5.8(c).

77. See § 6.5.

78. See § 9.3(e).

79. Reg. § 1.501(c)(3)-1(b).

80. Reg. § 1.501(c)(3)-1(b)(1).

81. Reg. § 1.501(c)(3)-1(b)(2).

82. IRC § 508(e)(1); Reg. § 1.508-3(a). See Chapters 5 to 9.

83. See Chapter 2 § 1.

84. Reg. § 1.508-3(c).

## INTRODUCTION TO PRIVATE FOUNDATIONS

The provisions of the governing instrument of a private foundation or applicable state law must require or prohibit, as the case may be, the foundation to act or refrain from acting so that the foundation, and any foundation managers or other disqualified persons with respect to the foundation, will not be liable for any of the private foundation excise taxes.<sup>85</sup> The governing instrument of a nonexempt split-interest trust<sup>86</sup> must contain comparable provisions in respect to any of the applicable private foundation excise taxes.<sup>87</sup>

Specific reference in the governing instrument to the appropriate sections of the Internal Revenue Code is generally required, unless equivalent language is used that is deemed by the IRS to have the same full force and effect. A governing instrument that contains only language sufficient to satisfy the requirements of the organizational test for charitable organizations in general, however,<sup>88</sup> does not meet the specific requirements applicable with respect to private foundations, regardless of the interpretation placed on the language as a matter of law by a state court.<sup>89</sup> A governing instrument of a private foundation does not meet these organizational requirements if it expressly prohibits the distribution of capital or corpus.<sup>90</sup>

A private foundation's governing instrument is deemed to conform with the requisite organizational requirements if valid provisions of state law have been enacted that require the foundation to act or refrain from acting so as not to subject it to any of the private foundation excise taxes or that treat the required provisions as being contained in the foundation's governing instrument.<sup>91</sup> The IRS ruled as to which state statutes contain sufficient provisions in this regard.<sup>92</sup>

Any provision of state law is presumed to be valid as enacted and, in the absence of state law provisions to the contrary, applies with respect to any private foundation that does not specifically disclaim coverage under state law (either by notification to the appropriate state official or by commencement of judicial proceedings).<sup>93</sup> If a state law provision is declared invalid or inapplicable with respect to a class of foundations by the highest appellate court of the state involved or by the U.S. Supreme Court, the foundations covered by the determination must meet the private foundation organizational requirements within one year from the date on which the time for perfecting an application for review by the Supreme Court expires. If this application is filed, these requirements must be met within one year from the date on which the Supreme Court disposes of the case, whether by denial of the application for review or decision

85. Reg. § 1.508-3(b)(1). Rev. Rul. 70-270, 1970-1 C.B. 135, contains sample governing instrument provisions.

86. See § 13.2.

87. Reg. § 1.508-3(b)(1). Rev. Rul. 74-368, 1974-2 C.B. 390, contains sample governing instrument provisions.

88. See text accompanied by *supra* note 79.

89. Reg. § 1.508-3(b)(1).

90. Reg. § 1.508-3(b). In one instance, a charitable testamentary trust was found to have violated the private foundation organizational rules because the trust instrument required the trust to accumulate, rather than distribute, income; a state court ordered modification of the instrument to provide for the requisite distribution of the foundation's income (*Estate of Lee H. Barnes*, 74-1 U.S.T.C. ¶ 9241 (Court of Common Pleas of Lancaster County, Pa. (1973))).

91. Reg. § 1.508-3(d)(1).

92. Rev. Rul. 75-38, 1975-1 C.B. 161.

93. Reg. § 1.508-3(d)(2)(i).

## § 1.8 PRIVATE FOUNDATION SANCTIONS

on the merits.<sup>94</sup> If a provision of state law is declared invalid or inapplicable with respect to a class of foundations by a court of competent jurisdiction, and the decision is not reviewed by the highest state appellate court or the Supreme Court, and the IRS notifies the general public that the provision has been declared invalid or inapplicable, then all private foundations in the state involved must meet these organizational requirements, without reliance on the statute to the extent declared invalid or inapplicable by the decision, within one year from the date the notice is made public.<sup>95</sup> These rules do not apply to a foundation that is subject to a final judgment entered by a court of competent jurisdiction, holding the law invalid or inapplicable with respect to the foundation.<sup>96</sup>

In one case, a charitable trust created by will in 1967 had its trust instrument amended by court order to enable the trust, a private foundation, to comply with the organizational requirements.<sup>97</sup> In a similar case, the trustees of a private foundation were permitted by a state court to modify a trust document to facilitate compliance by the foundation with these organizational rules.<sup>98</sup>

## § 1.8 PRIVATE FOUNDATION SANCTIONS

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

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

Indeed, these excise taxes are more accurately characterized as penalties. For example, the legislative history of the self-dealing rules is replete with references to the tax sanctions as “penalties.” The report of the House Committee on Ways and Means accompanying its version of the 1969 tax legislation stated that the “permissible activities of private foundations . . . are substantially tightened to *prevent* self-dealing between the foundations and their substantial contributors.”<sup>99</sup> The Committee added that it “has determined to generally *prohibit* self-dealing transactions and provide a variety and graduation of sanctions.”<sup>100</sup> In this report there are numerous references to these sanctions as constituting “prohibitions” or arising out of “prohibited” conduct. Identical or similar language appears in the report of the Senate

94. Reg. § 1.508-3(d)(2)(ii).

95. Reg. § 1.508-3(d)(2)(iii).

96. Reg. § 1.508-3(d)(2)(iv).

97. *Matter of Jeanne E. Barkey*, 71-1 U.S.T.C. ¶ 9350 (Surrogate’s Court of New York County, NY (1971)).

98. *William Wikoff Smith Trust Estate*, “*The W. W. Smith Foundation*,” 72-1 U.S.T.C. ¶ 9271 (C.P. Montgomery County Orphans’ Court, Pa. (1971)). In general, Anthony, Jr., “Private Foundation Governing Instrument Requirements: Connecticut Public Acts Nos. 219 and 220,” 46 *Conn. B. J.* 287 (1972); Brorby, “Using State Law to Amend Foundations’ Governing Instruments Under 508(e),” 34 *J. Tax.* 170 (1971).

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

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

## INTRODUCTION TO PRIVATE FOUNDATIONS

Committee on Finance in its version of the 1969 legislation.<sup>101</sup> This continues to be the view of Congress on the subject, in that a report of the Ways and Means Committee issued in 1996 refers to the private foundation rules as a “penalty regime.”<sup>102</sup>

The courts, as well, view these private foundation tax provisions as penalties. For example, two federal appellate courts rejected the argument that the self-dealing taxes are mere excise levies and held that these taxes are penal in nature.<sup>103</sup> This wide-ranging view that the private foundation rules are sanctioned by penalties inevitably leads to the view that the rules broadly encompass foundations’ operations. Certainly the IRS accords the broadest of interpretations to this area of the law and, correspondingly, strict and narrow readings as to the exceptions.

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

The private foundation rules collectively stand as devices Congress created for the purpose of curbing what was perceived as a host of abuses being perpetrated through the use of private foundations by those who control or manipulate them (disqualified persons).<sup>104</sup> Congress addressed the problems from several directions, principally through prohibitions on self-dealing,<sup>105</sup> mandatory payouts for charitable purposes,<sup>106</sup> prohibitions on substantial holdings of business enterprises,<sup>107</sup> prohibitions on engaging in jeopardizing (speculative) investments,<sup>108</sup> and a cluster of other banned activities, the funding of which is considered taxable expenditures.<sup>109</sup> These and other related provisions comprise Chapter 42 of the Internal Revenue Code. Similar constraints were placed on certain supporting organizations and donor-advised funds 2006.<sup>110</sup>

The taxes imposed for violation of the private foundation rules are structured as a tripartite level of taxation: initial (first-tier) taxes, additional (second-tier) taxes, and the involuntary termination (third-tier on confiscation) taxes. The first and second of these taxes are characterized as excise taxes and are outlined in Exhibit 1.2.<sup>111</sup> The

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

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

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

104. See Chapter 4.

105. See Chapter 5.

106. See Chapter 6.

107. See Chapter 7.

108. See Chapter 8.

109. See Chapter 9.

110. See Chapters 15 and 16.

111. The specifics of these excise taxes for each of the sets of private foundation rules are the subject of the last sections of Chapters 5 to 9.

**EXHIBIT 1.2 Private Foundation Excise Taxes**

SANCTION	TAX IMPOSED ON		INITIAL TAX		ADDITIONAL TAX	
	PRIVATE FOUNDATION	MANAGERS	1ST-TIER RATE	IMPOSED	2ND-TIER RATE	ASSESSED
Section 4940 Investment Income Tax	X		2%	Of investment income imposed annually when Form 990-PF filed. (see chapter 10.2 for reducing rate 1%.)	N/A	Not applicable.
	X		1%	Tax reduced by 1 percent for PFs increasing grants annually.		
Section 4941 Self-Dealing		On self-dealer X	10%	Of "amount involved" for each year transaction outstanding.	200%	If self-dealing not "corrected."
		On manager X	5%	Of "amount involved" for each year transaction outstanding. Participating managers jointly and severally liable; can agree to allocate among themselves; maximum for managers \$10,000.	50%	If manager refuses to agree to part or all of correction. Maximum additional tax \$10,000.
Section 4942 Undistributed Income	X		30%	Of "undistributed income" for each year undistributed.	100%	For each year income remains undistributed.
Section 4943 Excess Business Holdings	X		10%	On fair market value of excess holdings each year.	200%	Of excess holdings at end of "taxable period."
Section 4944 Jeopardizing Investments	X		10%	On amount so invested for each year of "taxable period."	25%	Of amount not removed from jeopardy.
		X	10%	On amount so invested for each year of investment. Participating managers jointly and severally liable for maximum tax of \$5,000 per investment.	5%	Of amount on managers who refused to agree to part or all of removal from jeopardy; maximum for management \$10,000.
Section 4945 Taxable Expenditures	X		20%	Of each taxable expenditure.	100%	Of uncorrected expenditure at end of "taxable period."
		X	5%	Of each taxable expenditures for manager who knew of and agreed to the expenditure. Maximum for all managers \$5,000.	50%	Of amount on manager who refuses to correct all or part of taxable amount; maximum amount \$10,000.

## INTRODUCTION TO PRIVATE FOUNDATIONS

third of these taxes is imposed when the IRS requires termination of the foundation due to flagrant violations of the rules.<sup>112</sup> Form 4720 is filed to report the incidents and calculate any taxes due.<sup>113</sup>

The penalty provisions of these excise taxes do not contain exception, or excuse, for imposition of the penalty on the private foundation for failure to comply with the specific provisions. The regulations accompanying these provisions, however, contain relief for those foundation managers who do not condone, or participate in the decision to conduct, a prohibited action. Until 1984, the penalties were strictly applied.<sup>114</sup> Congress in 1984 added statutes<sup>115</sup> to permit abatement of the penalties imposed on both the foundation and its managers if it is established to the satisfaction of the IRS that:

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

To allow abatement, the actions of the responsible foundation officials must be considered. Although one of these provisions<sup>116</sup> is titled “Definitions,” neither it nor the regulations define the terms *reasonable cause* or *willful neglect*. There have not been any court decisions and only one IRS private determination<sup>117</sup> concerning abatement of these penalties. In a ruling concerning a taxable expenditure penalty for failure to seek advance approval of a scholarship plan, there was no mention of abatement.<sup>118</sup>

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

For the foundation’s penalty to be abated, its managers must also prove that the failure was due to reasonable cause and not to willful neglect. A bankruptcy judge found that a trustee had not demonstrated conscious, intentional, or reckless indifference in failing to file a return or obtain an extension, so reasonable cause for abating penalties existed.<sup>119</sup>

Under the general rules pertaining to tax penalties,<sup>120</sup> the determination of whether a taxpayer’s actions were due to reasonable cause in good faith is made on a case-by-case basis. According these rules, “generally, the most important factor is the

112. See Chapter 13.

113. This form is reproduced as Exhibit 12.1 in Chapter 12.

114. *Charles Stewart Mott Foundation v. United States*, 91-2 U.S.T.C. ¶ 50340 (6th Cir. 1991); *Mannheimer Charitable Trust, Hans S. v. Commissioner*, 93 T.C. 35 (1989).

115. IRC §§ 4961–4963.

116. IRC § 4962.

117. Tech. Adv. Mem. 9424004. See Chapter 7, note 127.

118. Priv. Ltr. Rul. 9825004.

119. *United States Bankruptcy Court of Central District of California re Molnick’s Inc.*, 95-1 U.S.T.C. ¶ 95,751 (9th Cir. 1995).

120. Reg. § 1.6664-4(b); see also §§ 8.4 and 9.8.

### § 1.8 PRIVATE FOUNDATION SANCTIONS

extent of the taxpayer's effort to access the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." This regulation provides that reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. This type of reliance, however, constitutes reasonable cause and good faith if, under all the circumstances, the reliance was reasonable and the taxpayer acted in good faith. Reliance on the opinion or advice of a professional is considered reasonable cause if:

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

The second-tier taxes may also be abated.<sup>121</sup>

When enacted in 1969, the private foundation rules were unique. The statutory scheme devised by Congress had no precedent in the tax law. (The only other prior occasion when Congress levied a tax on otherwise tax-exempt organizations was on adoption of the tax on unrelated business income, implemented in 1950.<sup>122</sup>) But in the immediate aftermath of enactment of the foundation rules, speculation started as to whether and to what extent this new approach might be extended to other tax-exempt organizations, principally public charities.<sup>123</sup> Since then, the rules engendered to reform the conduct of private foundations have been replicated, in varying degrees, by Congress four times, principally with respect to the operations of public charities: taxes on lobbying expenditures,<sup>124</sup> taxes on political campaign expenditures,<sup>125</sup> and taxes on the rendering of excess benefits to disqualified persons.<sup>126</sup> Thus, private foundations law set in motion the use of a tax scheme that has been utilized since and undoubtedly will be used again. But the amount of interpretative law built up around these statutory rules is most extensive in respect to private foundations.

121. IRC § 4961.

122. See Chapter 11.

123. E.g., Raattama, Jr., "Private Foundations: Then and Now," 19 *Univ. of Miami Philip E. Heckerling Inst. on Estate Planning* 11 (1985); Morris, "Public Charities: Maintaining Their Favored Public Status," 11 *N.Y.U. Conf. on Char. Fdns.* 179 (1973); Troyer, "Public Charities and 1969 Act: A Look Ahead," 10 *N.Y.U. Conf. on Char. Fdns.* 109 (1971).

124. IRC §§ 4911 and 4912.

125. IRC § 4955.

126. IRC § 4958.

