Contents

Preface xxi

Chapter One Introduction to Private Foundations 1
§ 1.1 PRIVATE FOUNDATIONS: UNIQUE ORGANIZATIONS 1
§ 1.2 DEFINITION OF PRIVATE FOUNDATION 6
§ 1.3 HISTORY AND BACKGROUND 7
§ 1.4 FOUNDATIONS IN OVERALL EXEMPT ORGANIZATIONS CONTEXT 11
§ 1.5 DEFINITION OF CHARITY 12
§ 1.6 OPERATING FOR CHARITABLE PURPOSES 13
§ 1.7 ORGANIZATIONAL RULES 17
§ 1.8 PRIVATE FOUNDATION SANCTIONS 19

Chapter Two Starting and Funding a Private Foundation 25
§ 2.1 CHOICE OF ORGANIZATIONAL FORM 25
§ 2.2 FUNDING A FOUNDATION 27
§ 2.3 ESTATE PLANNING PRINCIPLES 29
(a) Decedents’ Estates 29
(b) Estate and Gift Tax Considerations 30
§ 2.4 FOUNDATIONS AND PLANNED GIVING 30
(a) Introduction to Planned Giving 30
(b) Charitable Remainder Trusts 31
(c) Other Planned Giving Vehicles 32
(d) Interrelationships with Private Foundation Rules 33
§ 2.5 ACQUIRING TAX-EXEMPT STATUS 34
(a) Preparing Form 1023 35
(b) The Substantially Completed Application 86
(c) Recognition Application Procedure and Issuance of Determination Letters and Rulings 89
(d) Application Processing Timeline 91
(e) Issues Causing Applications to Be Routed to EO Technical 91
(f) User Fees 92
§ 2.6 SPECIAL REQUIREMENTS FOR CHARITABLE ORGANIZATIONS 92
§ 2.7 WHEN TO REPORT BACK TO IRS 95
(a) When Should a Ruling Be Requested? 95
(b) Changes in Tax Methods 96
(c) Amended Returns 98
Chapter Three Types of Private Foundations

§ 3.1 PRIVATE OPERATING FOUNDATIONS
(a) Direct Charitable Distributions
(b) Grants to Other Organizations
(c) Individual Grant Programs
(d) Income Test
(e) Asset, Endowment, or Support Test
(f) Compliance Period
(g) Advantages and Disadvantages of Private Operating Foundations
(h) Conversion to or from Private Operating Foundation Status
(i) Exempt Operating Foundations

§ 3.2 CONDUIT FOUNDATIONS
§ 3.3 COMMON FUND FOUNDATIONS
§ 3.4 RESEARCH AND EXPERIMENTATION FUNDS
§ 3.5 OTHER TYPES OF FOUNDATIONS
§ 3.6 NONEXEMPT CHARITABLE TRUSTS
§ 3.7 SPLIT-INTEREST TRUSTS
§ 3.8 FOREIGN PRIVATE FOUNDATIONS

Chapter Four Disqualified Persons

§ 4.1 SUBSTANTIAL CONTRIBUTORS
§ 4.2 FOUNDATION MANAGERS
§ 4.3 CERTAIN 20 PERCENT OWNERS
§ 4.4 FAMILY MEMBERS
§ 4.5 CORPORATIONS OR PARTNERSHIPS
§ 4.6 TRUSTS OR ESTATES
§ 4.7 PRIVATE FOUNDATIONS
§ 4.8 GOVERNMENTAL OFFICIALS

Chapter Five Self-Dealing

§ 5.1 PRIVATE INUREMENT DOCTRINE
§ 5.2 PRIVATE BENEFIT DOCTRINE
§ 5.3 DEFINITION OF SELF-DEALING
(a) Six Specific Acts
(b) Statutory Exceptions
(c) Exceptions Provided in Regulations
§ 5.4 SALE, EXCHANGE, LEASE, OR FURNISHING OF PROPERTY
(a) Transactions by Agents
(b) Exchanges
(c) Leasing of Property
CONTENTS

(d) Furnishing of Goods, Services, or Facilities 165
(e) Co-owned Property 167

§ 5.5 LOANS AND OTHER EXTENSIONS OF CREDIT 170
(a) Gifts of Indebted Property 171
(b) Interest-Free Loans 172

§ 5.6 PAYMENT OF COMPENSATION 173
(a) Definition of Personal Services 173
(b) Definition of Compensation 176
(c) Definition of Reasonable 177
(d) Finding Salary Statistics 180
(e) Commissions or Management Fees 183
(f) Expense Advances and Reimbursement 184
(g) Bank Fees 185
(h) IRS Executive Compensation Study 186

§ 5.7 INDEMNIFICATION AND INSURANCE 190
(a) Noncompensatory Indemnification and Insurance 190
(b) Compensatory Indemnification and Insurance 191
(c) Fringe Benefit Rules and Volunteers 192

§ 5.8 USES OF INCOME OR ASSETS BY DISQUALIFIED PERSONS 194
(a) Securities Transactions 195
(b) Payment of Charitable Pledges 195
(c) For the Benefit of Transactions 196
(d) Incidental or Tenuous Benefits 197
(e) Memberships 202
(f) Benefit Tickets 202
(g) Other Acts 203

§ 5.9 SHARING SPACE, PEOPLE, AND EXPENSES 203
(a) Determining What the Private Foundation Can Pay 204
(b) Office Space and Personnel 204
(c) Group Insurance 206
(d) Public Facilities 206

§ 5.10 PAYMENTS TO GOVERNMENT OFFICIALS 208

§ 5.11 INDIRECT SELF-DEALING 209

§ 5.12 PROPERTY HELD BY FIDUCIARIES 213
(a) General Rules 213
(b) Control Situations 215

§ 5.13 EARLY TERMINATIONS OF CHARITABLE REMAINDER TRUSTS 216

§ 5.14 ADDITIONAL EXCEPTIONS 218

§ 5.15 ISSUES ONCE SELF-DEALING OCCURS 220
(a) Undoing the Transaction 220
(b) Amount Involved 223
(c) Date of Valuation 224
(d) Payment of Tax 225
(e) Advice of Counsel 228
Chapter Six Mandatory Distributions

§ 6.1 DISTRIBUTION REQUIREMENTS—IN GENERAL 233
§ 6.2 ASSETS USED TO CALCULATE MINIMUM INVESTMENT RETURN 235
  (a) What Are Investment Assets? 236
  (b) Future Interests or Expectancies 237
  (c) Exempt Function Assets 237
  (d) Dual-Use Property 239
  (e) Assets Held for Future Charitable Use 240
  (f) Acquisition Indebtedness 241
§ 6.3 MEASURING FAIR MARKET VALUE 242
  (a) Valuation Methods 243
  (b) Date of Valuation 243
  (c) Partial Year 243
  (d) Readily Marketable Securities 244
  (e) Unique Assets 245
  (f) Cash and Other Types of Assets 246
§ 6.4 DISTRIBUTABLE AMOUNT 248
  (a) Controversial Addition 249
  (b) Distribution Deadline 250
§ 6.5 QUALIFYING DISTRIBUTIONS 251
  (a) Direct Grants 252
  (b) Direct Charitable Expenditures 256
  (c) Controversial Proposal 260
  (d) Set-asides 260
  (e) Distributions to Foreign Recipients 264
§ 6.6 DISTRIBUTIONS TO CERTAIN SUPPORTING ORGANIZATIONS 266
§ 6.7 SATISFYING THE DISTRIBUTION TEST 268
  (a) Timing of Distributions 268
  (b) Planning for Excess Distributions 270
  (c) Calculating the Tax 271
  (d) Abatement of the Tax 272
  (e) Exception for Certain Accumulations 273
§ 6.8 HISTORY OF THE MANDATORY DISTRIBUTION REQUIREMENT 274

Chapter Seven Excess Business Holdings

§ 7.1 GENERAL RULES 279
  (a) Definition of Business Enterprise 280
  (b) Passive Income Businesses 280
CONTENTS

(c) Certain Investment Partnerships 281
(d) Percentage Limitations 283
§ 7.2 PERMITTED AND EXCESS HOLDINGS 285
(a) General Rules 285
(b) Partnerships, Trusts, and Proprietorships 286
(c) Constructive Ownership 287
(d) Disposition Periods 287
§ 7.3 FUNCTIONALLY RELATED BUSINESSES 289
§ 7.4 RULES APPLICABLE TO CERTAIN SUPPORTING ORGANIZATIONS 291
§ 7.5 RULES APPLICABLE TO DONOR-ADVISED FUNDS 291
§ 7.6 EXCISE TAXES ON EXCESS HOLDINGS 291

Chapter Eight Jeopardizing Investments 295
§ 8.1 GENERAL RULES 296
(a) Defining Jeopardy 296
(b) Donated Assets 299
§ 8.2 PRUDENT INVESTMENTS 300
(a) Evaluating Investment Alternatives 302
(b) Facing the Unknown 304
(c) Risk versus Return 309
(d) Total Return Investing 309
(e) How Income Is Reported 311
(f) Measuring Investment Return 311
§ 8.3 PROGRAM-RELATED INVESTMENTS 313
§ 8.4 EXCISE TAXES FOR JEOPARDIZING INVESTMENTS 317
(a) When a Manager Knows 317
(b) Reliance on Outside Advisors 319
(c) Removal from Jeopardy 319

Chapter Nine Taxable Expenditures 323
§ 9.1 LEGISLATIVE ACTIVITIES 325
(a) Law Applicable to Charities Generally 325
(b) Law Specifically Applicable to Private Foundations 326
(c) Grants to Charities That Lobby 328
(d) Nonpartisan Study of Social Issues 331
(e) Self-Defense Exception 332
§ 9.2 POLITICAL CAMPAIGN ACTIVITIES 333
(a) Law Applicable to Charities Generally 333
(b) Law Specifically Applicable to Private Foundations 334
(c) Voter Registration Drives 335
§ 9.3 GRANTS TO INDIVIDUALS 336
(a) Grants for Travel, Study, or Other Purposes 337
CONTENTS

(b) Other Individual Grants 338
(c) Compensatory Payments 341
(d) Selection Process 342
(e) Employer-Related Programs 343
(f) Reports and Monitoring 347
(g) Seeking Approval 349
(h) Individual Grant Intermediaries 352

§ 9.4 GRANTS TO PUBLIC CHARITIES 354
(a) Rationale for Public Charities Grants 354
(b) Documenting Public Charity Grants 355
(c) The Reliance Problem 357
(d) Intermediary Grantees 361

§ 9.5 GRANTS TO FOREIGN ORGANIZATIONS 361

§ 9.6 EXPENDITURE RESPONSIBILITY 365
(a) General Rules 365
(b) Pre-Grant Inquiry 368
(c) Grant Terms 371
(d) Monitoring System 374
(e) Reports from Grantees 374
(f) Grantee’s Procedures 377
(g) Reliance on Grantee Information 377
(h) Reports to IRS 377
(i) Retention of Documents 379
(j) Grantee Diversions 380

§ 9.7 INTERNET AND PRIVATE FOUNDATIONS 381
(a) Exempt Status Issues 382
(b) Providing Information 383
(c) Providing Services 383
(d) Links 384

§ 9.8 SPENDING FOR NONCHARITABLE PURPOSES 386

§ 9.9 DISTRIBUTIONS TO CERTAIN SUPPORTING ORGANIZATIONS 389

§ 9.10 EXCISE TAX FOR TAXABLE EXPENDITURES 389
(a) Tax on Managers 390
(b) Paying or Abating the Tax 391
(c) Additional Tax 391
(d) Correcting the Expenditure 392

Chapter Ten Tax on Investment Income 395

§ 10.1 RATE OF TAX 396

§ 10.2 REDUCING THE EXCISE TAX 397
(a) Qualification for 1 Percent Rate 397
(b) Distributing, Rather than Selling, Property 399
(c) Another Tax Reduction Possibility 401

xiv
CONTENTS

§ 10.3 FORMULA FOR TAXABLE INCOME 402
(a) Gross Investment Income 402
(b) Capital Gains and Losses 403
(c) Interest 405
(d) Dividends 407
(e) Rentals 407
(f) Royalties 407
(g) Estate or Trust Distributions 407
(h) Partnerships 408
(i) Questionable Taxable Gains before 2007 409

§ 10.4 REDUCTIONS TO GROSS INVESTMENT INCOME 411
(a) Deductions Allowed 414
(b) Deductions Not Allowed 415

§ 10.5 FOREIGN FOUNDATIONS 417

§ 10.6 EXEMPTION FROM TAX 417

Chapter Eleven Unrelated Business Income 419
§ 11.1 GENERAL RULES 420
(a) Overview 420
(b) Trade or Business Income 420
(c) Substantially Related Activity 424
(d) Regularly Carried on 426
(e) Real Estate Activities 427

§ 11.2 EXCEPTIONS 429
(a) Royalties 430
(b) Rents 431
(c) Research 433
(d) Nonbusiness Activities 434
(e) Revenue Produced on the Internet 434

§ 11.3 RULES SPECIFICALLY APPLICABLE TO PRIVATE FOUNDATIONS 436
(a) Business Enterprises 436
(b) Permitted Businesses 438
(c) Partnerships and S Corporations 439

§ 11.4 UNRELATED DEBT-FINANCED INCOME 442
(a) Acquisition Indebtedness 442
(b) Related-Use Exceptions 444
(c) Includible Income 445

§ 11.5 CALCULATING AND REPORTING THE TAX 445

Chapter Twelve Tax Compliance and Administrative Issues 449
§ 12.1 SUCCESSFUL COMPLETION OF FORM 990-PF 453
(a) Part I, Analysis of Revenue and Expenses 455
(b) Line-by-Line Instructions 456
CONTENTS

(c) Expense Allocations 462
(d) Part II, Balance Sheets 464
(e) Part III, Analysis of Changes in Net Worth or Fund Balances 465
(f) Part IV, Capital Gains and Losses for Tax on Investment Income 465

§ 12.2 REPORTS UNIQUE TO PRIVATE FOUNDATIONS 466
(a) Part V, Qualification for Reduced Tax on Net Investment Income 466
(b) Part VI, Excise Tax on Investment Income 467
(c) Part VII-A, Statements Regarding Activities 468
(d) Part VII-B, Statements Regarding Activities for Which Form 4720 May Be Required 471
(e) Part VIII, Information about Officers, Directors, Trustees, Foundation Managers, Highly Paid Employees, and Contractors 473
(f) Part IX-A and B, Summary of Charitable Activities 474
(g) Part IX-B, Summary of Program-Related Investments 475
(h) Part X, Minimum Investment Return 475
(i) Part XI, Distributable Amount 475
(j) Part XII, Qualifying Distributions 475
(k) Part XIII, Undistributed Income 476
(l) Part XIV, Private Operating Foundations 477
(m) Part XV, Supplementary Information 477
(n) Part XVI-A, Analysis of Income-Producing Activity and Part XVI-B, Relationship of Activities 478
(o) Part XVII, Information Regarding Transfers to and Transactions and Relationships with Noncharitable Exempt Organizations 481

§ 12.3 COMPLIANCE ISSUES 482
(a) Historic Public Inspection Requirements 482
(b) Document Dissemination Rules 482
(c) Where and When to File Form 990-PF 486
(d) First-Year Issues 486
(e) Reporting Violations and Other IRS Issues 487
(f) Employment Tax Considerations 489
(g) Reporting Requirements for Offshore Investments 489

Chapter Thirteen Termination of Foundation Status 555
§ 13.1 VOLUNTARY TERMINATION 557
§ 13.2 INVOLUNTARY TERMINATION 558
§ 13.3 TRANSFER OF ASSETS TO A PUBLIC CHARITY 559
(a) Terms of Transfer 560
(b) Reservation of Rights 562
(c) Eligible Public Charity Recipients 563
§ 13.4 OPERATION AS A PUBLIC CHARITY 565
§ 13.5 MERGERS, SPLIT-UPS, AND TRANSFERS BETWEEN FOUNDATIONS 567
CONTENTS

(a) IRS Road Map for Reforming a Foundation 567
(b) Questions Answered in Ruling 568
(c) Unanswered Question 574

§ 13.6 TERMINATION TAX 578
§ 13.7 ABATEMENT 579

Chapter Fourteen Charitable Giving Rules 581
§ 14.1 GENERAL RULES 581
   (a) Deduction Variables 581
   (b) Percentage Limitations 582
   (c) Estate and Gift Tax Deductions 583
§ 14.2 GIFTS OF APPRECIATED PROPERTY 583
§ 14.3 DEDUCTIBILITY OF GIFTS TO FOUNDATIONS 585
§ 14.4 DEDUCTION REDUCTION RULES 586
   (a) Capital Gain Property Deduction Rule 586
   (b) Qualified Appreciated Stock Rule 586
   (c) Other Deduction Reduction Rules 588
§ 14.5 PLANNED GIVING REVISITED 588
§ 14.6 ADMINISTRATIVE CONSIDERATIONS 589
   (a) Substantiation Rules 589
   (b) Disclosure Rules 590
   (c) Appraisal Rules 590
   (d) Reporting Requirements 592
   (e) State Fundraising Regulation 592

Chapter Fifteen Private Foundations and Public Charities 593
§ 15.1 DISTINCTIONS BETWEEN PUBLIC AND PRIVATE CHARITIES 594
§ 15.2 EVOLUTION OF LAW OF PRIVATE FOUNDATIONS 596
§ 15.3 ORGANIZATIONS WITH INHERENTLY PUBLIC ACTIVITY 598
   (a) Churches 599
   (b) Educational Institutions 599
   (c) Hospitals and Other Medical Organizations 601
   (d) Public College Support Foundations 602
   (e) Governmental Units 603
§ 15.4 PUBLICLY SUPPORTED ORGANIZATIONS—DONATIVE ENTITIES 603
   (a) General Rules 604
   (b) Support Test 608
   (c) Facts and Circumstances Test 611
   (d) Community Foundations 612
   (e) Community Foundation Compliance Check Project 614
§ 15.5 SERVICE PROVIDER ORGANIZATIONS 615
   (a) Investment Income Test 618
   (b) Concept of Normally 620
# CONTENTS

Appendix A  Sources of the Law  677  
Appendix B  Internal Revenue Code Sections  689  
Table of Cases  691  
Table of IRS Revenue Rulings and Revenue Procedures  695  
Table of IRS Private Determinations Cited in Text  699  
Table of IRS Private Determinations Discussed in *Bruce R. Hopkins’ Nonprofit Counsel*  705  
Table of IRS Private Letter Rulings, Technical Advice Memoranda, and General Counsel Memoranda  707  

Index 723