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Beyond Grantmaking: Additional Mechanisms for Mission

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Reference Outline

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I. INTRODUCTION

According to statistics compiled from the National Center for Charitable Statistics, there are more than 86,000 foundations in the United States with more than 78,000 being classified as independent foundations (i.e. private non-operating foundations that are not corporate foundations).[1] Private non-operating foundations generally do not directly perform charitable programs or services, but rather pursue their charitable purposes through their grant-making activities. In 2013, foundations gave nearly $55 billion for charitable purposes (approximately $37 billion came from independent foundations).[2] In the aggregate, grant-making private foundations make hundreds of thousands of grants annually, funding many diverse areas from education and health to arts, the environment, public affairs, religion, and scientific research. However, these broad categories, while garnering the most grant dollars, do not constitute an exclusive list. Rather, grant-making foundations may make grants for any purpose considered exempt under Section 501(c)(3) so long as certain rules of the road are obeyed.

While making an enormous impact through their grant dollars, grant-making foundations have a rich history of going beyond their grant-making programs. There is a subset of private foundations and philanthropists who desire more involvement. They want to leverage their expertise, to supplement their grant-making dollars, and to invest strategically and programmatically. At the same time, these foundations continue to be subject to the prohibited transaction rules set out in the Internal Revenue Code (the "Code"). How will program expenses for charitable activities be treated under the minimum distribution requirement rules of Section 4942? Will a strategic investment into a low-income area of the community at less than fair market rates without security be a jeopardizing investment under Section 4943 of the Code? Is there a better way to structure a foundation who decides to change focus and conduct only charitable activities? Should a foundation create a new entity to put a liability shield between its charitable activities other than passive grant making and its endowment? These questions, and others, will be considered in this paper.

II. PRIVATE FOUNDATIONS IN CONTEXT

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. The Code defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) that does not qualify under one of the specifically-enumerated categories of public charities set out in § of the Code. Private foundations, as a result of a perceived lack of public oversight and accountability, are subject to a series of provisions in the Code describing excise taxes that, with the exception of the net investment income excise tax, are imposed for certain actions of the foundation.

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[1] *See* The Foundation Center, *Key Facts on U.S. Foundations*, 2014 (visited Nov. 29, 2016) <foundationcenter.org/gainknowledge/research/keyfacts2014/>.
[2] *See id.* (citing *Giving USA Foundation*, Giving USA, 2013).

A. Excise Tax on Investment Income (I.R.C. § 4940)

A private foundation is subject to an excise tax of 2% of its net investment income and, unlike the excise taxes listed below, this tax is unavoidable. The excise tax may be reduced from 2% to 1% provided that the foundation meets a "maintenance of effort" test.[3] The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor's death. The ordinary and necessary expenses paid or incurred for the production and collection of such income and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

B. Minimum Distribution Requirements (I.R.C. § 4942)

A private foundation must generally distribute approximately 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation (e.g., the distribution requirement is based on the foundation's investment assets). This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes. A foundation has until the end of the next tax year to satisfy the minimum payout requirement for that taxable year. Generally, a private foundation's qualifying distributions will consist of grants to qualified charitable organizations (§ 501(c)(3) public charities). (Private foundations may no longer count grants or payments to supporting organizations classified as non-functionally integrated Type III supporting organizations or that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.) Qualifying distributions also include grants to non-charities for "charitable purposes," costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

C. Excess Business Holdings (I.R.C. §4943)

To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation's ability to engage in certain business activities. A private foundation may own up to 20% of the voting power in a business enterprise, reduced by the percentage of voting stock held by all disqualified persons. If control of the entity can be shown to be held by

[3] The foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

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