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Summary of Federal Tax Rules Governing Private Foundations

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The federal tax rules governing private foundations by and large are more restrictive than the rules governing public charities. A special set of provisions set forth in sections 4940-4945 of the Internal Revenue Code of 1986, as amended (the "Code") imposes excise taxes on various activities and expenditures. These provisions, as well as certain other rules, are summarized below.

I. <u>Mandatory Payout Requirement</u>

Section 4942 of the Code requires that a private foundation distribute a minimum amount of money and/or property in the form of "qualifying distributions" each year. To meet this requirement, a foundation generally must distribute an amount equivalent to at least 5% of the average fair market value of its net investment assets annually.[1] A foundation must make its qualifying distributions for a given fiscal year on or before the last day of the following fiscal year.[2] A foundation that fails to meet this requirement must pay an initial excise tax of 30% on its undistributed income, plus a tax of 100% on such amount if the required distributions are not made within a specified period.[3]

"Qualifying distributions" generally include any amount paid to accomplish charitable purposes – such as grants – as well as any amount paid to acquire an asset used directly in carrying out one or more exempt purposes. In addition to grants, the former category may include program-related investments and reasonable and necessary administrative expenses.[4] "Program-related investments" are defined as investments the primary purpose of which is to accomplish one or more charitable purposes and no significant purpose of which is the production of income or the appreciation of property.[5] Examples of reasonable and necessary administrative expenses include salaries of employees who conduct the foundation's exempt purpose programs, overhead attributable to the activities of such employees, and legal fees incurred in accomplishing the foundation's exempt purposes.[6]

Please note that qualifying distributions do not generally include contributions to other private foundations (except private operating foundations) or to organizations controlled directly or indirectly by the private foundation or one or more disqualified persons with respect to the foundation.[7] In addition, qualifying distributions do not include contributions to a Type III supporting organization that is not functionally integrated, or to a Type I, Type II, or Type III functionally integrated supporting organization if such organization is directly or indirectly controlled by a disqualified person with respect to the private foundation.[8] As a consequence of these rules, private foundations will often only make grants to public charities and private operating foundations.

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[1] Code § 4942(a)–(e).
[2] Code § 4942(h)(1); Treas. Reg. § 53.4942(a)-3(d).
[3] Code § 4942(a)–(b).
[4] Code § 4942(g)(1); Treas. Reg. § 53.4942(a)-3(a)(2).
[5] Code § 4944(c); Treas. Reg. § 53.4944-3(a).
[6] Treas. Reg. § 53.4942(a)-3(a)(8), Ex. 1; Rev. Rul. 75-495.
[7] Code § 4942(g)(1), (3); Treas. Reg. § 53.4942(a)-3(a)(2), (c). The term "disqualified person" is defined by § 4946(a) for the purposes of all the excise tax provisions. With certain exceptions, the term is applied identically to all of the excise tax provisions. The definition is discussed in greater detail in Part IV below.
[8] Code § 4942(g)(4).

II. Tax on Net Investment Income

Section 4940 of the Code imposes an annual excise tax of 1% to 2% on a private foundation's net investment income.[9] Net investment income is defined as the amount by which a private foundation's gross investment income and net capital gains exceed allowable deductions, and generally includes interest, dividends, rents, and royalties, in addition to capital gain net income.[10] The default rate of tax is 2%. A private foundation qualifies for the reduced 1% rate if the qualifying distributions made by the foundation in a taxable year equal or exceed the sum of: (1) the assets of the foundation multiplied by the foundation's average percentage payout of qualifying distributions during the five immediately preceding years, plus (2) 1% of the foundation's net investment income.[11] A foundation must estimate and pay the excise tax quarterly using IRS Form 8109-B.[12]

III. Taxable Expenditures

Section 4945 of the Code imposes an excise tax on specific activities defined collectively as "taxable expenditures." Private foundations that make taxable expenditures must pay an initial excise tax equal to 20% of the expenditures, plus a tax of 100% of such amount if the expenditures are not eliminated within a stated period. Foundation managers who agree to expenditures knowing they are taxable must pay an initial excise tax equal to 5% of the expenditures, plus a tax of 50% of such amount if they refuse to correct the expenditures (the initial and additional tax liabilities for managers are limited to $10,000 and $20,000, respectively, per taxable expenditure).[13] Because the tax imposed by section 4945 is so significant, it essentially prohibits private foundations from engaging in the activities covered by the provision.

Subject to certain qualifications, "taxable expenditures" include amounts paid or incurred:

- To carry on propaganda or otherwise attempt to influence legislation through direct or grassroots lobbying;[14]
- To influence the outcome of a specific public election except with respect to certain voter registration drives;[15]

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[9] Code § 4940(a); Treas. Reg. § 53.4940-1(a).
[10] Code § 4940(c); Treas. Reg. § 53.4940-1(c).
[11] Code § 4940(e).
[12] Code § 6655. Form 8109-B is available on the IRS website at http://www.irs.gov/pub/irs-pdf/f8109b.pdf.
[13] Code § 4945(a)–(b), (c)(2).
[14] Lobbying does not include making available the results of nonpartisan analysis, study, or research; providing technical advice or assistance to a governmental body or committee in response to a written request from such entity; or engaging in self-defense lobbying. Treas. Reg. § 53.4945-2(d)(1)–(3).
[15] Code § 4945(f); Treas. Reg. § 53.4945-3(b).

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