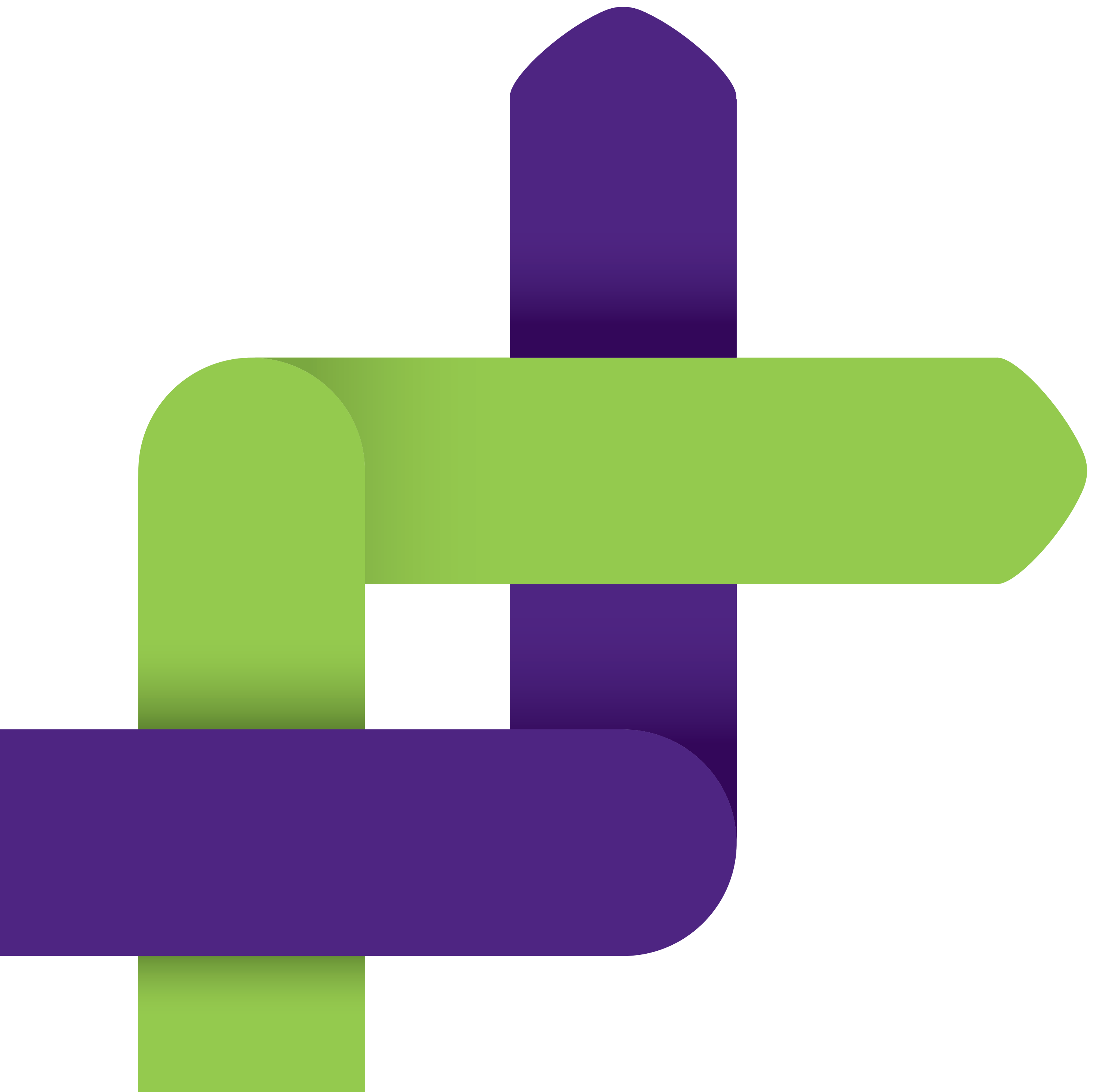
Grant Thornton

A tax how-to guide for private foundations



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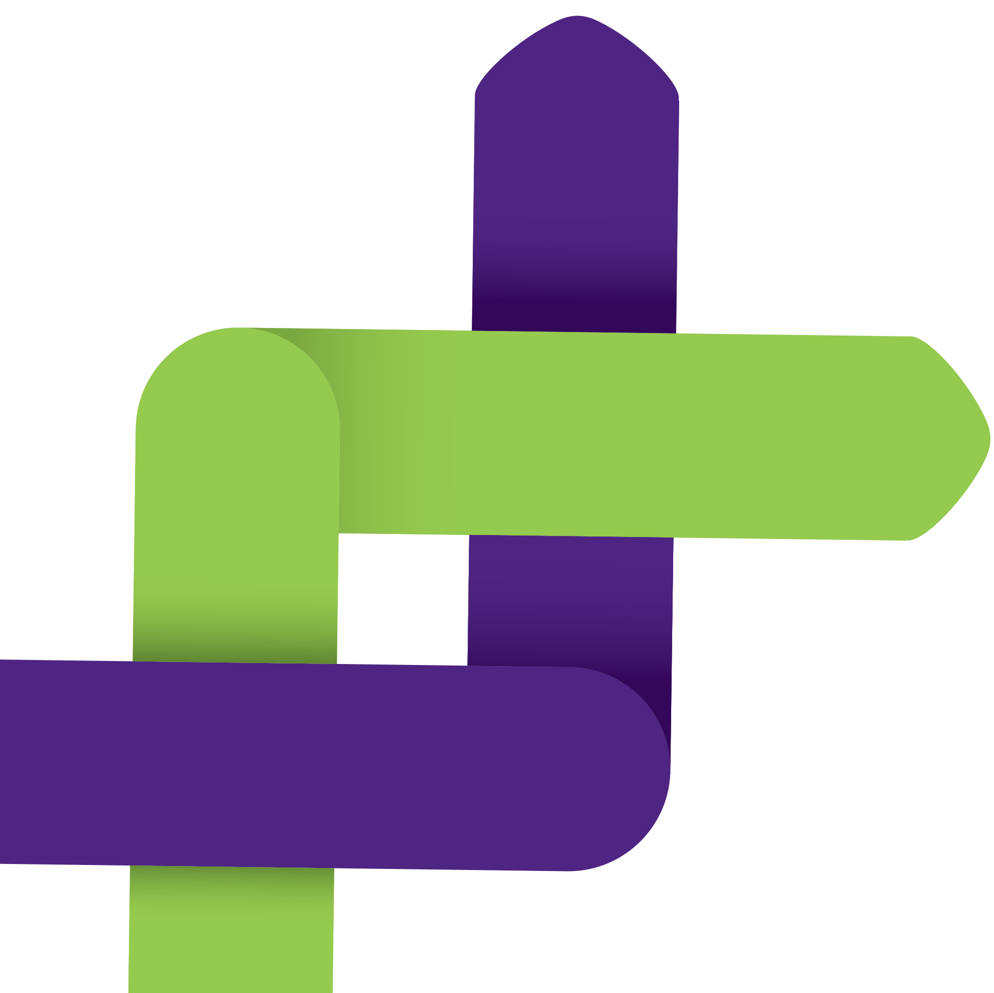


Introduction

Despite enjoying tax-exempt status, private foundations are not immune to taxation. Yes, as long as a private foundation does not engage in activities unrelated to its tax-exempt mission, it will not be subject to any income taxes; however, private foundations, unlike their public charity counterparts, are potentially subject to an assortment of excise taxes. They are subject to the complex tax rules of Chapter 42 of the Internal Revenue Code (IRC); navigating those rules is crucial to effective tax planning.

The tax professionals of Grant Thornton LLP address the issues confronting private foundations on a daily basis, from excess business holdings to self-dealing, from expenditure responsibility compliance to unrelated business income tax planning. Our experience is broad, and we have served all types of private foundations, from small family foundations to some of the largest private grant-making foundations in the world.

No question is trivial.

Because compliance with the IRC can be daunting, we offer this digestible Q&A guide to some of the issues you're likely to encounter.

If you have further questions, contact us. We're here to help.

Visit our website for insights and more information about how we can assist your private foundation.

How to: Apply and file

Q: How does an organization apply to the IRS for private foundation status, and what are the general filing requirements?

A: All organizations seeking exemption under Section 501(c)(3), whether public charities or private foundations, obtain recognition of tax-exemption from the IRS by completing a Form 1023 and paying the required user fee.

Private foundations are required to file an annual return with the IRS: Form 990-PF, Return of Private Foundation. Depending on where the private foundation conducts business and/or is incorporated, it will have a corresponding state filing. For purposes of this publication, we will use New York as our reference point. The annual filing in New York for private foundations is the CHAR500.

Apply for recognition of tax-exempt status

Before an organization seeks exemption from taxation from the IRS, it must complete a few preliminary steps:

- The organization must be legally formed. Generally, this means incorporating (creating a corporation). If the foundation is structured as a trust, a trust document is necessary.
- The corporation must prepare articles of incorporation and bylaws, and foundations must include all of the provisions required under Section 501(c)(3) of the IRC to obtain exemption.
  - A charitable purpose clause — The organizing documents must have a charitable purpose clause (i.e., an overt statement of those charitable activities the foundation intends to engage in).
  - A limitation on lobbying clause — As a tax-exempt organization, the private foundation may not engage in substantial lobbying activity. A Section 501(c)(3) tax-exempt organization may not engage in any political activities (e.g., no endorsements of specific candidates for office). Contact Grant Thornton tax professionals for an explanation of the differences between lobbying and political activities.
  - A private inurement clause — The income and/or assets of the organization must be dedicated to a charitable purpose and may not inure to the benefit of any private individual.
  - A charitable dissolution clause — Upon dissolution, the private foundation's assets must be distributed to a 501(c)(3) organization.
- The organization must obtain an Employer Identification Number (EIN) from the IRS. This process is simple and can be done online.

Once the organization has completed these initial steps, it should submit an application to the IRS. Private nonoperating foundations fall under §501(c)(3) of the IRC and must complete the Form 1023, Application for Recognition of Exemption. As of Jan. 31, 2020, Form 1023 must be submitted via an online application, and a user fee is required. See here for Rev. Proc. 2012-8. Certain smaller tax-exempt organizations may submit Form 1023-EZ in lieu of Form 1023. As indicated by its name, Form 1023-EZ is a simplified version of the exemption application that is processed much more quickly by the IRS.

The Form 1023 process is intended to be streamlined and issue-free, but, often, the IRS will require supplemental information from the organization seeking exemption. Given the likelihood of additional IRS scrutiny, Grant Thornton usually recommends that the organization submit Form 1023 through the representation of a third party — a power of attorney. If a third party assists the applicant, Form 2848, Power of Attorney and Declaration of Representative, should accompany the Form 1023 application. See here for more details.

When Form 1023 is filed with the IRS, it is assigned to an agent for review. The review process usually takes six to 12 months, depending on whether the IRS has additional inquiries for the applicant. In our experience, the review process rarely concludes in less than six months, even if the applicant requests expedited approval.

After the IRS approves the application for exemption, it issues a determination letter recognizing the organization as a private foundation. The IRS determination letter is one of the most important documents the organization will own during its existence. It should be retained in a central location and available at all times, because donors may request a copy to "prove" that the foundation is a tax-exempt entity.

We recommend the organization maintain its Form 1023 exemption application in a central location as well. Form 1023 is a public document, and the foundation must allow for public inspection and copying of the application if anyone requests it. The IRS also makes these documents available for public inspection and copying. To obtain a copy of any organization's Form 1023 exemption application (including your own), an applicant needs only to file a Form 4506-A.

Form 990-PF must be filed by the 15th day of the fifth month following the close of the organization's accounting period. For example, for calendar-year foundations, Form 990-PF is due on May 15. If the information necessary to file the return is not available by the deadline, the organization may file one six-month extension. Referring back to our example, a calendar-year foundation's Form 990-PF extended due date is Nov. 15 — 11 months after the year-end.

Beginning July 2, 2019, all private foundation returns must be electronically filed. By returns, the IRS is referring to any type of IRS filing such as Form W-2 or Form 1099. Since most foundations are operated by very few employees, most are not compelled to e-file.

Taking into account any extensions granted, if an organization fails to file Form 990-PF by the due date, it will have to pay $20 for each day the return is late — $105 per day for large organizations — not to exceed the lesser of $10,500 ($53,000 for "large organizations") or 5% of the organization's gross receipts, unless it shows that the failure was due to reasonable cause.

Q: Can an organization be treated as tax-exempt while its Form 1023 application is pending with the IRS?

A: As long as Form 1023 is filed within the first 27 months of incorporation, the applicant will be presumed to be tax-exempt from the date of incorporation even though it has not received formal recognition of exemption. The organization may act like a private foundation even without the IRS ruling, via a determination letter. It must file a Form 990-PF in a timely manner to report its activities, and it can issue acknowledgment letters to donors and represent itself as a private foundation to the public. The only caveat: If the application is ultimately rejected or denied, the organization is required to inform donors that their donation is nondeductible and they may be required to amend previous tax filings. In our experience, this scenario is unlikely.

Q: What is a private foundation's annual tax filing obligation with the IRS?

A: Public charities file Form 990. If the public charity's gross receipts do not eclipse certain thresholds, the organization may be absolved from filing Form 990 or 990-EZ information return in any given year. An organization that is not required to file Form 990 is required to complete a Form 990-N postcard, which is filed online at www.irs.gov. Private foundations have no such threshold. All private foundations, regardless of whether they have taxable income or any activity at all during the year, are required to file Form 990-PF, Return of Private Foundation, annually. As noted earlier, even if the foundation has an exemption application pending with the IRS, it should file Form 990-PF; the instructions relating to Form 990-PF make this clear.

How to: Understand governance and deductions

Q: What are the rules and regulations governing private nonoperating foundations?

A: Nonoperating foundations are subject to many IRS rules that public charities, by contrast, are not. These rules are §§4940, 4941, 4942, 4943, 4944 and 4945.

Private foundations — operating and nonoperating — are subject to five unique excise taxes.

To encourage private foundations to fulfill their charitable mission — and to punish those that do not — Congress added a series of private foundation excise taxes to the IRC. Excise taxes are imposed on:

1. Self-dealing transactions
2. Excess business holding rules
3. Jeopardy investments
4. Taxable expenditures
5. Net investment income

1. Self-dealing transactions

Foundations are precluded from engaging in most transactions with related parties or "disqualified persons," as they are known in IRS parlance. Generally, a disqualified person is someone who manages the foundation or who has contributed a significant amount of funds to the foundation. A foundation should maintain an active listing of all disqualified persons to assure that the organization is not inadvertently violating the prohibitions on self-dealing. Individuals on this list include:

- Any foundation officer, director, trustee or employee with the authority to act on behalf of the foundation
- Any substantial contributor to the foundation
- Certain relatives of the disqualified persons listed above
- Certain entities owned or controlled by the people listed above

The IRC lists a number of transactions between a private foundation and a disqualified person that are presumed to be prohibited, including (see generally §4941):

- Sale of property by or to, exchange with or leasing from a disqualified person
- Lending of money or extension of credit by a private foundation to a disqualified person
- Furnishing of goods, services or facilities by a private foundation to a disqualified person
- Transferring income or assets of a foundation to, or for the use of, a disqualified person
- Payment of compensation by a private foundation to a disqualified person, unless the compensation is reasonable and is for personal services necessary to carry out the foundation's charitable functions

Because this concept can be confusing, we offer the following examples:

- **Attending fundraisers** — If the foundation buys a ticket to a fundraising event and the ticket price includes payment for goods and services (e.g., dinner and entertainment), the ticket cannot be used by a disqualified person except if the event is part of that individual's oversight responsibility. Use of such tickets by spouses of foundation personnel who do not have a role with the foundation is an area of particular concern to the IRS.

- **Hiring family members as staff or service providers** — You can hire a family member as staff and pay them a salary or fee, but the compensation must be reasonable, and the services necessary, personal (legal, accounting, banking, investment, etc.) and in furtherance of the foundation's charitable mission. The definition of personal services is narrow. For this reason, it is particularly important to consult with legal counsel when considering hiring family members as staff or service providers.

- **Compensating board members** — Most foundations do not compensate board members. However, such compensation is not prohibited as long as the fees are reasonable, especially if a family member sits on the board.

- **Providing scholarships** — The self-dealing rules prohibit scholarships or grants to benefit disqualified persons. For example, a family foundation cannot provide a scholarship for the grandchildren of the foundation's substantial donor.

- **Paying travel expenses for family** — The assets of a foundation generally cannot be used to finance the travel or any other expense of spouses and children who have no role in the foundation.

- **Renting space from a family member** — The foundation's payment of rent to any disqualified person is self-dealing, even if the rent charged is significantly below market rate and benefits the foundation. Note: A foundation may lease space from a disqualified person at no cost without it being self-dealing. This is frequently seen in the context of family and/or corporate foundations that operate out of the leased space of the corporation. The IRC has a specific exception for these types of situations.

Disqualified persons may make gifts to private foundations; in fact, many do. However, due to the self-dealing excise tax rules, foundations should generally avoid most transactions with disqualified persons and their related parties. The excise taxes, which range from 5% to 200% of the amount involved, are imposed on the self-dealer and on the foundation's management, but not directly on the foundation itself. See Addendum A for a more detailed discussion of the potential excise tax penalties.

2. Excess business holdings rules

Private foundations may not own substantial interests in a "business enterprise" such as a corporation or partnership. In general, a foundation has excess business holdings when it, together with all disqualified persons, owns more than 20% of the voting control of a business enterprise. Under certain circumstances, the 20% amount can be increased to 35%.

A business enterprise generally encompasses the active conduct of a trade or business, including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services and is an unrelated trade or business (under IRC §513). A business enterprise normally does not include a business that derives substantially all (usually defined as 95%) of its income from passive sources (e.g., dividends, interest, royalties and in some cases, real estate rents) or functionally related or program-related investments. The term "functionally related" business means:

- A trade or business that is not an unrelated trade or business (as defined in Section 513)

- An activity that is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that is related (aside from the organization's need for income or funds or its use of the profits derived) to the exempt purposes of the organization

Program-related investments are those in which:

- The primary purpose is to accomplish one or more of the foundation's exempt purposes

- The production of income or appreciation of property is not a significant purpose

- Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose

A 10% initial excise tax is imposed on the private foundation's excess business holdings. If the excess business holdings are not disposed of during the taxable period, the private foundation is subject to an additional tax equal to 200% of the excess business holdings. Note: The tax applies only to the foundation's excess business holdings. If it owns no interest in the enterprise (or up to a 2% de minimis amount), it will not be subject to the tax even if disqualified persons own more than 20%.

If a foundation acquires excess business holdings through a bequest or a gift, it may have up to five years to dispose of the holdings. In contrast, acquisition by other means (such as a purchase), may result in an immediate tax. A foundation should regularly monitor the business holdings owned by its disqualified persons.

Certain independently owned philanthropic organizations are not subject to the excess business holdings excise tax for years beginning after Dec. 31, 2017. The Bipartisan Budget Act of 2018 contained the Philanthropic Enterprise Act, which amended the excess business holdings rules to allow Newman's Own and similar private foundations to own businesses that meet certain conditions:

- **Hold 100% of voting stock**. The private foundation holds 100% of the voting stock of the philanthropic business.

- **Receive business by gift or bequest**. The private foundation received its ownership interests in the business by means other than purchase.

- **Independent foundation board**. The private foundation board has a majority of directors who are not directors or officers of the business enterprise or family members of a substantial contributor.

- **Business independent of donor family**. The business cannot have substantial contributors or their family members as directors, officers, employees or contractors, and cannot make any loans to substantial contributors or their family members.

- **All profits to charity**. The business must distribute its post-tax net operating income to the private foundation each year (with a reasonable reserve for business needs).

3. Jeopardy investments

When a private foundation makes an investment that could financially jeopardize the performance of its exempt purposes, both the foundation and the individual managers who approve the transaction may become liable for taxes on these jeopardizing investments under IRC §4944. Investments will be deemed "jeopardy investments" when the foundation's managers have not exercised ordinary business care and prudence in making the investment, particularly when the short- and long-term financial needs of the foundation have not been taken into account. The IRS will determine whether an investment jeopardizes the foundation's charitable purpose when the foundation makes the investment, rather than subsequently, based on hindsight.

There are no "per se" jeopardy investments; the IRS will review those that appear to present excessively high risk, such as commodity futures contracts, short sales, margin transactions, puts, calls and straddles.

A private foundation that makes investments that could financially jeopardize the performance of its exempt purpose is liable for an initial excise tax equal to 10% of the amount invested for each year (or part of a year) in the taxable period. If, at the end of the taxable period, the private foundation has not divested itself of the jeopardizing investment, an additional 25% tax may be imposed. The IRS may also levy punitive excise taxes on foundation managers considered to have knowingly participated in the investment decision.

4. Taxable expenditures

A taxable expenditure includes any amount paid or incurred by a private foundation for these purposes (see here for information about IRC Sec. 4945(d)):

- To carry on propaganda or otherwise attempt to influence legislation.
- To influence the outcome of any specific public election or to carry on — directly or indirectly — any voter registration drive (nonpartisan voter registration drives are not considered taxable expenditures).
- As a grant to an individual — except for awards on an objective and nondiscriminatory basis — for travel, study or other similar purposes by such individual.
- As a grant to an organization — other than an exempt private operating foundation or a public charity — unless the foundation exercises expenditure responsibility with respect to the grant. In general, expenditure responsibility means the donor foundation implements controls to ensure that the donee organization spends grant funds only for a charitable purpose.
- For any purpose other than the foundation's exempt purpose (i.e., a noncharitable expenditure).

These general rules have exceptions. For example, a private foundation may make grants to individuals for travel, study or similar purposes if the foundation's grant-making procedures have been previously approved by the IRS. The IRS has established a formal procedure for this preapproval of a foundation's grant programs. More information regarding this procedure is available from the authors upon request.

An initial excise tax equal to 20% of the amount of each taxable expenditure is imposed on the foundation. Likewise, an initial excise tax equal to 5% of the amount of each taxable expenditure is imposed on any foundation manager who, knowing that an expenditure is taxable, agrees to make the expenditure. The amount of tax imposed on all foundation managers is limited to $10,000 first tier and $20,000 second tier for any one taxable expenditure. A second-tier excise tax of 100% (foundation) and 50% (manager) is levied if the transaction is not remedied.

5. Net investment income

For tax years beginning after Dec. 20, 2019, foundations are generally subject to a flat 1.39% excise tax on their net investment income (e.g., interest, dividend, rents, royalties and capital gains). This tax is intended not to be punitive, but rather to pay the government's cost of regulating private foundations. Methods of calculating the net investment excise tax are covered further in this publication.

Q: Can a donor deduct a gift to a private nonoperating foundation as a charitable contribution?

A: Yes, in general, a charitable contribution to a private foundation by an individual or C corporation is deductible, but subject to the limitations imposed by the IRC.

Timing varies for deducting charitable contribution

As a general rule, an individual donor may deduct charitable contributions of money or property that he or she makes to, or makes available for the use of, a qualified organization, such as a private operating foundation. A donor may deduct a contribution to the extent that it does not exceed 50% of his or her adjusted gross income, but when a contribution is made to a nonoperating private foundation, a 30% limitation may apply. Charitable contributions are deductible only if a taxpayer itemizes deductions on Form 1040, Schedule A; see here for more information. Any amount not deducted in the year a contribution is made may be carried forward and taken in up to five years.

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the 2017 Tax Cuts and Jobs Act allows cash contributions up to 60% of an individual's contribution base. After Dec. 31, 2025, the limitation goes back to 50%.

With regard to a corporation, charitable contributions are generally deductible only on the tax return for the year the payment is made. However, an accrual-basis corporation can elect to shift the deduction from one year to another by proper timing of the directors' resolution authorizing the contribution. The deduction may be claimed in the year the resolution is adopted, provided that payment is actually made on or before the 15th day of the third month following the close of the year (e.g., March 15 for a calendar-year corporation).

The election to treat a contribution as paid during the tax year must be made at the time of filing the return for the year. If the election is made, a copy of the resolution of the board of directors authorizing the contribution or gift should be attached to the return, together with a verified declaration signed by the president or another principal officer of the corporation stating that the resolution was adopted during the tax year.

A corporation also has a five-year carryover period for charitable contributions that exceed 10% of its taxable income. The Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, temporarily increases the limit to 25% of taxable income for qualified contributions (cash contributions except for those made to Section 509(a)(3) organizations and donor advised funds). This five-year period is also available to acquiring corporations in tax-free reorganizations and to parent corporations in the case of a subsidiary's liquidation (IRC §170(b)(2)(A)).

Recordkeeping requirements for gifts to private foundations

A private foundation receiving a contribution of $250 or more must provide substantiation to the donor for donations of cash and noncash contributions (IRC §170(f)(8)(A)). A private foundation must provide the following written acknowledgment to donors:

- Name and address of the charitable organization
- Date and location of the contribution
- Amount of any cash contributed
- Description of any property contributed
- Whether the charitable organization provided any goods or services in return for the contribution
- Description and good-faith estimate of the value of any goods or services the charitable organization provided in return (IRC §170(f)(8))

To the extent the foundation receives any noncash contributions and ultimately disposes of them, it may be required to file Form 8282. Consult your tax adviser for more information pertaining to Form 8282.

How to: Identify unrelated business income

Q: What constitutes unrelated business income (UBI) for a private foundation, and what are the tax reporting requirements if a private foundation derives UBI?

A: Revenues derived from certain types of activities that are not substantially related to the foundation's primary exempt purpose may constitute UBI. If a private foundation has gross UBI exceeding $1,000, it is required to file Form 990-T.

Definitions determine UBI

Organizations exempt from income tax under §501(c) of the IRC will not be liable for tax on any revenue generated from activities related to the organization's exempt purpose. Nevertheless, §511 imposes a tax on the UBI of such organizations. This unrelated business tax is computed using regular corporate income tax rates, or trust rates if the organization is set up as such.

Generally, the gross income of a tax-exempt organization will constitute taxable UBI if three factors are present:

1. It is income from a trade or business.
2. The trade or business is regularly carried on by the organization.
3. The conduct of the trade or business is not substantially related to the organization's performance of its tax-exempt function (IRC §512(a)(1); IRC Reg. 1.513-1).

The term "trade or business" generally means any activity carried on for the production of income from selling goods or performing services (IRC Reg. 1.513-1(b)). Selling goods or performing services from which gross income is derived does not lose its identity as a trade or business merely because it is carried on within a larger framework of activities related to the exempt purposes of the organization. It should be noted that the IRS position is that an activity that continually loses money is not a trade or business unless support to the contrary can be provided.

Business activities of an exempt organization ordinarily will be considered to be "regularly carried on" if they show a frequency and continuity, and are pursued in a manner similar to comparable commercial activities of nonexempt organizations (See generally, IRC Reg. 1.513-1(c)). This determination is entirely fact-dependent.

Determining whether a business activity is "substantially related" requires an examination of the relationship between the business activities that generate the income in question and the accomplishment of the organization's exempt purpose (See generally, IRC Reg. 1.513-1(d)). To be substantially related, activities that generate the income must contribute importantly to the accomplishment of the organization's exempt purposes. If the income is not substantially related, it would be deemed taxable.

The IRC contains a number of modifications, exclusions and exceptions to UBI. Overall, activities that are carried on for the production of income on a frequent and continual basis, and have no substantial relationship to the achievement of the organization's exempt purpose, are classified as unrelated unless they are specifically excluded by the IRC. Statutory modifications to the definition of UBI include these passive activities:

- Dividends and interest from passive activities (IRC §512(b)(1))
- Royalties (IRC §512(b)(2))
- Rental income from real property (IRC §512(b)(3))
- Gains and losses from the sale of property other than inventory (IRC §512(b)(5))

Passive activities usually don't generate UBI

Since most nonoperating private foundations do not undertake any active programs or activities, they do not conduct any direct unrelated business activities. They aren't selling goods and/or services, they aren't leasing out properties, and they aren't actively vying with commercial enterprises. Where a private foundation typically derives UBI is through its passive investment activities. While passively derived income is generally excluded from UBI, that exclusion is forfeited if this income is derived from investment assets that are debt-financed.

Under IRC §512(b)(4), income that would otherwise be excluded from taxation under IRC §§512(b)(1), (b)(2), (b)(3) and (b)(5) — e.g., dividends, interest, royalties, rents, and certain gains or losses from the sale of property — are deemed UBI if two conditions are met:

1. The income arises from property acquired or improved with borrowed funds.
2. The production of income is unrelated to the purpose constituting the basis of the organization's tax exemption.

Simply put, if the private foundation borrows money to invest in an income-producing venture, the revenues derived from that venture will constitute UBI. This is frequently seen in two contexts:

1. The foundation mortgages a building it owns and rents the premises to other organizations/individuals. Rental income derived from the mortgaged building may generate UBI. The debt-financing rules include many complexities, such as what constitutes acquisition indebtedness, how to compute acquisition indebtedness and what deductions available on property can be treated as debt-financed. For further information, see IRS Publication 598 or contact a tax professional.

2. The foundation invests in limited partnerships that may use debt to purchase underlying investments, or less commonly, the foundation borrows money to buy securities (e.g., on margin).

For the most part, a private foundation will derive UBI through its investment in, as an example, a partnership fund whose underlying investments may be involved in debt-financed real estate transactions or operating income that will pass through to the investor. Generally, these investments will generate a Schedule K-1 that should be issued to the foundation. K-1s are required to categorize that portion of income/loss that is derived from UBI sources. UBI can be readily identifiable as long as the foundation categorizes and tracks the K-1s to ensure capture of all potential taxable activity.

Other than these types of activities, most foundations will not engage in UBI. Common revenue sources, like contributions, will not constitute UBI. Under IRC §102, essentially all contributions are excluded from gross income as gifts — irrespective of whether the donee is a corporation, individual or tax-exempt organization — as long as the donee provides no value in exchange for the contribution.

For tax years beginning after Dec. 31, 2017, organizations with more than one unrelated trade or business must compute unrelated business taxable income (UBTI) separately for each trade or business, and losses from one unrelated business cannot be used to offset the income from a separate trade or business (Reg. §1.512(a)-6).

Q: If a private foundation does generate UBI, what expenditures may it utilize to offset its income?

A: The expense allocation method is key.

Identifying the income associated with an unrelated trade or business is only the first step: The more challenging step is to identify expenses that are allowable as deductions. To be deductible, expenses must be directly connected with the carrying on of an unrelated trade or business. The expenses must have a proximate and primary relationship to the carrying on of that business (Reg. §1.512(a)-1(a)), and they must be reasonable (Reg. §1.512(a)-1(c)).

A method of allocation meets the proximately and primarily related test if the expenses allocated are attributable solely to the conduct of unrelated business activities (Reg. §1.512(a)-1(b)).

Where property is used both for exempt and nonexempt purposes (a dual use), the proximately and primarily related test is met if the method allocates the expenses on a reasonable basis. By definition, the second "reasonableness" standard set forth in Reg. 1.512(a)-1(c) indicates the IRS anticipated more than one method of allocation. Accordingly, a reasonable method of apportioning expenses must be allowed, even though it may not be the best method. Whether a method of allocating expenses is a reasonable one is a factual determination.

For example, Rensselaer Polytechnic Institute v. Commissioner, 732 F.2d 1058 (2d Cir. 1984), is often cited as authority for an organization's reasonable allocation of expenses to dual-use facilities. The institute allocated fixed expenses based on a ratio of commercial use time over the total time the facility was in actual use. The IRS challenged the methodology and argued that the denominator of the ratio should be the total time available for use, not total actual use. Therefore, the IRS' methodology would result in a smaller ratio and less expense allocated to the commercial use. The court decided in favor of the institute, concluding that its expense allocation methodology was reasonable.

Q: When must a foundation file Form 990-T?

A: Filing Form 990-T is wise for any level of UBI.

Private foundations deriving UBI are required to file Form 990-T, as long as gross income from unrelated business activity exceeds $1,000. For purposes of continuity, recordkeeping or simply avoidance of any unwarranted notices from the IRS, we recommend our clients file Form 990-T even if the gross unrelated taxable income does not exceed $1,000.

UBI is taxed at ordinary corporate tax rates, or trust rates for those organized as such. Private foundations expecting to generate taxable income exceeding $500 (§6655(f)) are required to make estimated tax payments. Estimated tax payments generally are made in four installments: on the 15th day of the fifth, sixth, ninth and 12th months of the tax year (§6655(c)).

To the extent that a private foundation's unrelated business activity generates a taxable loss, that loss may be carried forward. An organization must track net operating losses (NOL) that originated in tax years beginning before Jan. 1, 2018, separately from those that originated in tax years beginning after Dec. 31, 2017, as the NOL carryforward rules differ in those periods. For all losses incurred prior to tax years beginning after Dec. 31, 2017, the carryforward period is 20 years; for all losses incurred thereafter, foundations enjoy an indefinite carryforward period. An NOL schedule should be attached to the return to preserve the loss. The CARES Act allows a deduction for an NOL for tax years 2018, 2019 and 2020 to be carried back to the five preceding tax years (IRC Sec. 172(b)(1)(D)).

A private foundation may also generate a capital loss from the sale of securities. This loss can be carried forward for five years, at which time it will expire.

How to: Calculate tax rates

Q: How is net investment income tax calculated?

A: For tax years beginning after Dec. 20, 2019, domestic tax-exempt private foundations are subject to an annual excise tax of 1.39% on their net investment income (IRC Sec. 4940(a)).

Computing net investment income is easier than many think

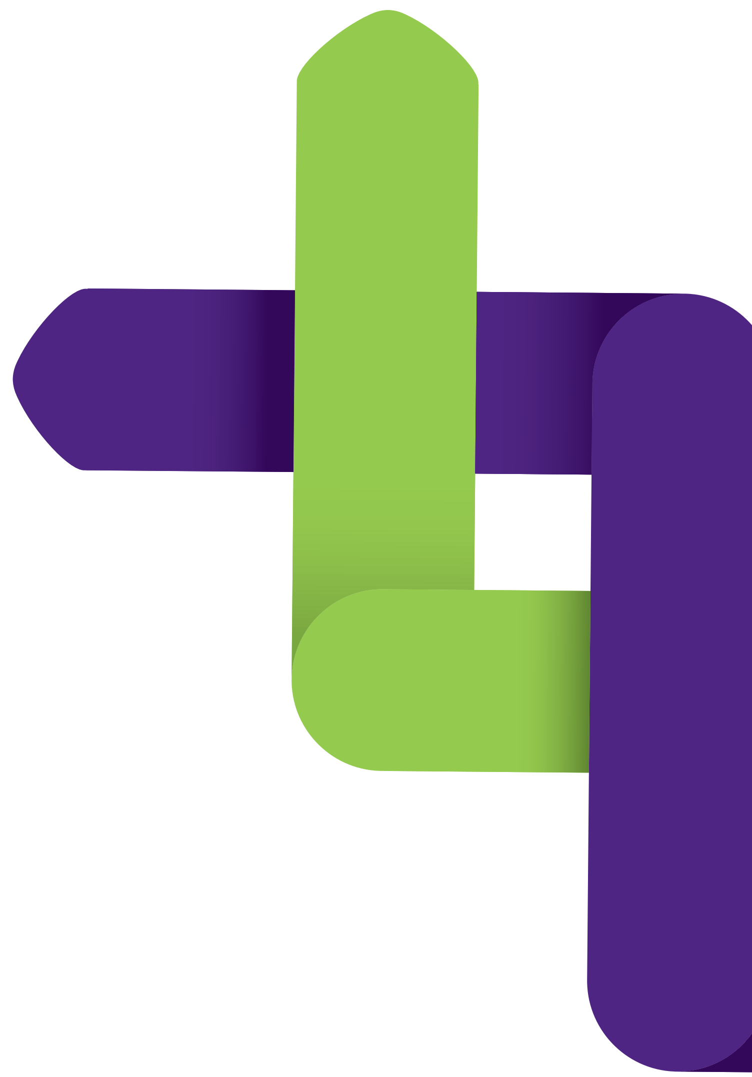
Private foundations are taxed on their net investment income. Revenues earned from contributions, grants and activities related to the foundation's charitable mission do not constitute investment income, so they are not subject to tax. The calculation for net investment income is simple:

Gross investment income
+ Capital gain net income
– Allowable deductions

Gross investment income is the total revenue from interest (other than tax-exempt interest), dividends, rents, royalties, income from loaned securities and investments in limited partnerships (IRC Sec. 4940(c)(2)). There are many other exotic, rarely seen types of investment income (Reg. §53.4940-1(d)(1) and 1.512(b)-1(a)).

It's important to note that revenue (e.g., rent, royalties and limited partnership income) taxed for UBI tax purposes may not be taxed again as investment income. Essentially, once the revenue is taxed at UBI tax corporate rates, that same revenue is not then taxed at the 1.39% excise rate (IRC Sec. 4940(c)(2)). To illustrate, a private nonoperating foundation's UBI from rental activities will not be included in gross investment income.

When determining net investment income, a foundation may deduct all ordinary and necessary expenses incurred for the production or collection of gross investment income or for the management, conservation or maintenance of property held for the production of that income, with certain modifications. Deductible expenses include the portion of the foundation's operating expenses (e.g., officers' compensation, employees' salaries, outside professional fees, interest and occupancy expenses). Excise taxes previously paid may not be used to offset net investment income.



How to: Meet your annual distribution requirement

Q: What is a nonoperating foundation's annual distribution requirement?

A: A nonoperating foundation is entitled to tax exemption, not because it undertakes any charitable activity per se (although it can do so); it receives its tax exemption because it supports the charitable endeavors of other public charities through grants. In recognition of this "duty" to support charitable endeavors, the IRS requires nonoperating foundations to make a minimum amount of annual qualifying distributions. Failure to do so may result in the assessment of a fairly steep excise tax.

A nonoperating foundation's primary exempt mission is to distribute grants to charities that undertake active charitable programs. The IRS ensures that a foundation adheres to this mission by requiring it to make a minimum annual distribution.

The most common type of qualifying distribution is a grant to a Section 501(c)(3) public charity (and to other organizations for which the foundation has maintained expenditure responsibility). In addition, necessary and reasonable administrative expenditures that are incurred to further the foundation's charitable mission will constitute qualifying distributions. Typical administrative expenditures that are deemed charitable are employee salary costs, grant administration costs, legal and accounting costs, and any expenses that enable a foundation to further its mission.

As long as a foundation's qualifying distributions exceed its minimum distributable amount, it will have fulfilled its annual distribution requirement and will not be subject to an excise tax for failure to distribute.

How to calculate minimum distribution

A foundation's annual distribution requirement is calculated on its annual Form 990-PF by analyzing the foundation's noncharitable use assets. Noncharitable use assets are essentially a foundation's investments — those assets that do not directly enable the foundation to carry on its charitable activity, but that may enable it to create wealth to support future charitable endeavors. These noncharitable use assets accumulate earnings at an extremely low tax rate (1.39%), and, in exchange, the IRS requires the foundation to make annual qualifying distributions equal to 5% of the foundation's net noncharitable use assets (IRC §4942(e)(1)). This is called the foundation's annual minimum investment return. Refer to Part X of Form 990-PF.

The foundation calculates the average fair market value of its noncharitable use assets over the course of the tax year. See the example in the following table.

Using the table below, the foundation's net value of noncharitable use assets is $17,695. The IRS deems 1.5% of the noncharitable use assets to be held for charitable activities; accordingly, the foundation's minimum investment return is $871. The foundation is permitted to reduce its minimum investment return by any excise or income taxes it has paid during the year. Assuming those taxes weren't paid, the foundation's distributable amount is $871 for the year.

The IRS distributions are very forgiving; a foundation is provided a full-year grace period in which to meet its distribution requirement. Let's assume the above distribution requirement is calculated on the foundation's Dec. 31, 2021, Form 990-PF. The $871 distributable amount, as reported on Part XIII of Form 990-PF, must be distributed before the end of Dec. 31, 2022. The sooner the foundation files its Form 990-PF (e.g., in May or August 2022), the sooner it will be aware of its distribution obligation to avoid potential penalties.

A foundation that fails to make its minimum distribution requirement is subject to an excise tax of 30% on the undistributed income. Using the example above and assuming the foundation distributes only $371 by year-end, the foundation will be subject to an excise tax of $150 (at a 30% rate). For every succeeding year the foundation fails to distribute the $500 shortfall, it will be subject to a 100% excise tax on the shortfall. Additionally, payment of the excise tax is required in addition to, rather than instead of, making required distributions of undistributed income.

Let's assume that our foundation has a distribution requirement of $5,000 in the succeeding year. It will be required to distribute the $500 shortfall from the prior year in addition to its $5,000 distribution. Failure to do so can result in both the 100% additional excise tax on the $500 and the initial tax of 30% on the $5,000.

Month	Average cash $	Average securities $
January	100	1,000
February	50	5,000
March	250	150,000
April	350	47,500
May	75	40,000
June	65	30,000
July	800	2,.500
August	575	1,000
September	400	3,500
October	250	15,000
November	325	12,000
December	100	1,000
Average Fair Market Value	**$278**	**$17,417**

How to: Maintain expenditure responsibility

Q: What due diligence procedures must a private foundation undertake when issuing domestic grants?

A: Private foundations are not inherently charitable entities. Unlike a public charity that receives its support from a broad swath of the public and is thus beholden to the public to perform some communal good (e.g., the amelioration of poverty, prevention of cruelty to animals, etc.), a private foundation is granted exemption from the IRS with the expectation that it will support the charitable missions of other public charities. Failure to meet this expectation results in severe excise taxes and ultimately may result in loss of tax exemption. To preserve its exemption on a year-to-year basis, a private foundation is required to make certain qualifying distributions to U.S. Section 501(c)(3) public charities (or Section 501(c)(3) equivalents) in accordance with a formula specified by the IRS.

Qualifying distributions are defined as follows:

1. Amounts paid to accomplish one or more charitable, religious, educational or other similar purposes. This may include reasonable and necessary administrative expenses (e.g., legal and accounting fees, and office expenses). These expenses are reported on Form 990-PF, Part I, column (d).
2. Amounts paid to acquire or operate program-related investments.
3. Certain amounts set aside for specific charitable projects.
4. Amounts paid to acquire assets used (or held for use) directly in carrying out the organization's charitable purpose.

Essentially, a qualifying distribution is a grant of cash, stock or property to a Section 501(c)(3) public charity (or Section 501(c)(3) equivalent).

Before making a grant to an organization, a private foundation should make a pre-grant inquiry to determine if the grantee is a Section 501(c)(3) public charity. Best business practices would require the private foundation to obtain a copy of the grantee's IRS determination letter. However, in practice, many grantees often have lost that letter or misplaced it.

In these instances, the recommended course is to check the IRS Publication 78 database that acts as a central repository of all public charities. This database can be searched by name or EIN on the IRS website. Alternatively, the foundation can obtain a copy of the grantee organization's most recently filed Form 990 on the GuideStar website or, infrequently, on the grantee organization's website, where the private foundation may review Schedule A to determine whether the grantee is a permissible Section 501(c)(3) grantee.

Q: What due diligence procedures must a private foundation undertake when issuing foreign grants?

A: When a private foundation makes a grant to a nonqualified organization, including a foreign organization, a U.S. nonoperating private foundation, a tax-exempt support organization or a corporate entity that pursues a charitable initiative, but doesn't have tax exemption, it must establish procedures to (§4945(h), Regulation §53.4945-5(b)(1)):

- See that the grant is spent solely for the purpose for which it was made
- Obtain full and complete reports from the grantee on how the funds were spent
- Make full reports with respect to the expenditures to the IRS

This is called exercising expenditure responsibility. Many foundations exercise expenditure responsibility even where the grantee appears to satisfy the equivalency determination rules, because doing so provides an extra layer of protection from a finding that the payment is an impermissible taxable expenditure.

How does a private foundation maintain expenditure responsibility? Essentially, it is a five-step process:

1. Conduct a pre-grant inquiry.
2. Enter into a written agreement that dictates the terms of the grant and establishes a reporting system for the grantee.
3. Request periodic grantee reports on the status of the grant (e.g., how the funds were spent and the grantee's progress toward achieving the grant purpose).
4. Make an annual disclosure to the IRS on the foundation's Form 990-PF.
5. Investigate any diversions of funds.

The private foundation must disclose, as part of its annual Form 990-PF, those grants for which it maintained expenditure responsibility. To comply with IRS requirements, the private foundation attaches an expenditure responsibility report to Form 990-PF that includes the following information (Reg. §53.4945-5(d)(2)):

- The name and address of the grantee
- The date and amount of the grant
- The purpose of the grant
- The amounts expended by the grantee
- Information about whether the grantee has diverted any portion of the funds
- The dates of any reports received from the grantee
- The date and results of any verification of the grantee's reports undertaken by or at the direction of the grantor private foundation

Failure to maintain expenditure responsibility can result in the foundation being assessed an excise tax for engaging in a taxable expenditure. Due diligence with respect to foreign grants is extremely important, and the law is nuanced. It is best to seek additional assistance if your organization makes grants to non-501(c)(3) organizations.

How to: Recognize an operating foundation

Q: What is an operating foundation, and how do I know if we are one?

A: For the most part, this guide addresses nonoperating foundations, primarily because operating foundations are less common. Simply put, a nonoperating foundation makes grants to other organizations that in turn conduct tax-exempt activities, and it doesn't do anything inherently charitable.

Operating foundations, on the other hand, conduct charitable activities. They are essentially hybrid organizations because they are treated for some purposes as a public charity while still being subject to the same restrictions and excise taxes that apply to nonoperating foundations.

Some important distinctions between operating and nonoperating foundations are:

- Donations to operating foundations qualify for a 50% adjusted gross income limitation (for deducting a charitable contribution), while donations to nonoperating private foundations are restricted to a 30% limitation (IRC §170(b)(1)(B)). Donations to operating foundations are eligible for the 60% (for 2018 through 2025, 50% after 2025) charitable contribution deduction limitation.
- Operating foundations are permissible recipients of qualifying distributions from private foundations.
- Operating foundations are not subject to the §4942 excise tax related to the failure to distribute income (IRC §4942(a)(1)).

A common question is this: If an operating foundation undertakes charitable activities, why does it not then qualify as a public charity? The answer is that to qualify as a public charity, an organization must receive most of its funding from public sources, e.g., contributions. If the organization receives funding from only one person or from a small group of donors, that organization will be categorized as a private foundation.

A foundation's status as a private operating foundation is reconfirmed and calculated annually on Form 990-PF (Reg. 53.4942(b)-3). To continue to qualify as an operating foundation, a foundation must satisfy both an income test and one of three additional tests (an asset, endowment or support test) in three out of the four tax years ending with the current year or in the aggregate over the four-year period (§4942(j)(3); Reg. 53.4942(b)-1 and Reg. 53.4942(b)-3(a); IRC §4942(j)(5)). Consequently, a private foundation may qualify as an operating foundation in one year, but not in the succeeding year. In those years in which it does not qualify as an operating foundation, the foundation will revert to nonoperating status.

The tests to determine whether a private foundation qualifies as an operating foundation are complicated. For further information, contact a tax professional.

Addendum A — Nonoperating foundation self-dealing rules

The self-dealing rules are designed to provide a sanction in the form of an excise tax applied to the wrongdoer or self-dealer, or possibly to a foundation manager participating in the transaction. It is important to note that the foundation itself is not assessed for a violation of the self-dealing rules.

A self-dealer could be assessed a 10% excise tax

When a violation occurs, the disqualified person (individual or legal entity) who enters the financial transaction with the foundation is the "self-dealer"; a 10% excise tax may be applied to that person. The excise tax is applied for each year in which the self-dealing transaction is not corrected.

Illustration: A foundation paid the travel expenses for a board member's spouse who had no foundation duties. The spouse could be assessed a tax equal to 10% of the expenses and would be required to repay the expenses to the foundation. The travel expenses were paid on April 1, 2019, but were not corrected until Sept. 15, 2021. A 10% tax can be assessed for the tax years 2019, 2020 and 2021.

A foundation manager could be assessed a 5% excise tax

An excise tax of 5% of the amount involved may be assessed to any foundation manager (board member or employee) who participates in self-dealing, in the event that the foundation manager knows that the act is self-dealing and willfully participates. An exception can be made when participation is not willful and is due to reasonable cause (e.g., reliance on written opinion of legal counsel). This initial tax may not exceed $20,000 for each act of self-dealing.

Correction must be made to avoid additional tax

In addition to paying the excise tax, the self-dealer must correct or undo the transaction to the extent possible (e.g., repaying the travel expenses). In no case will the resulting financial position of the foundation be worse than if the disqualified person were dealing under the highest fiduciary standards.

An additional or second-tier tax may be applied if the transaction is not corrected within a specified time period. The additional tax on the self-dealer is 200% of the amount involved. For foundation managers, the second-tier tax is 50%, not to exceed $20,000 with respect to each act of self-dealing. Second-tier taxes are rarely applied and normally occur when a self-dealer is unwilling to correct the transaction.

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