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USING THE FORM 990-PF AS A GUIDE

Best Practices for Private Foundations:

What They *Must* Do, *Must Not* Do and *May* Do

The Internal Revenue Service estimates that it takes approximately 33 hours and 33 minutes to prepare a private foundation's information return, the Form 990-PF.[1] Although trustees generally do not perform this specialized task, they need to be aware that Congress, state attorneys general, the media and the public are scrutinizing Forms 990-PF now more than ever before. News stories exposing excessive trustee compensation and exorbitant administrative expenses have cast an unflattering spotlight on private foundations, and the Form 990-PF is a popular tool for uncovering information on these issues.

Trustees[2] have a duty to adhere to the mission of the private foundation and to ensure that assets are managed properly. Trustees sometimes fail to realize that private foundations are multifaceted institutions with multiple legal, administrative and grantmaking functions. Trustees need to understand these functions in order to fulfill their legal and fiduciary duties. Trustees who do not do this run the risk of exposing the private foundation and themselves to financial liability and unwanted media attention.

This manual highlights some of the things private foundations *must* do, *must not* do and *may* do. It describes how trustees can use the Form 990-PF to examine the inner workings of a private foundation. In fact, the Form 990-PF is a useful "check-up" mechanism for evaluating the overall "health" of a private foundation. This manual identifies sections of the Form 990-PF that reveal possible improprieties, and suggests "best practices" to avoid violating the private foundation rules.

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What Is a Private Foundation?

A private foundation—like any other 501(c)(3) organization—is organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals. None of its earnings may benefit any private shareholder or individual; nor may a substantial part of its activities include carrying on propaganda or otherwise attempting to influence legislation or the outcome of any political campaign.[3]

The chief factors that distinguish a private foundation from a public charity are revenue sources and level of financial support. A public charity generally receives a substantial part of its funding directly or indirectly from the general public or from the government. Its public support must be fairly broad, and not come from just a few individuals or families.[4] A private foundation, on the other hand, usually receives its support from a limited number of sources—a single person, family or corporation. Moreover, private foundations are subject to rules imposing a tax on investment income; prohibiting self-dealing, excess business holdings and jeopardizing investments; and restricting accumulation of income and expenditures. [IRC §§ 4940–4945] The private foundation rules are discussed in Sections IV, V and VI.

A. CHOOSING THE LEGAL FORM

A private foundation can be organized as a trust or as a corporation. Regardless of the form, state law governs a private foundation's formation and operation.[5] Listed below are potential advantages and disadvantages of each form:

Advantages of the trust form:

- The regulations for setting up and operating a trust are generally more flexible than those for setting up and operating a corporation. For example, states generally impose few or no regulations on trusts with respect to board meetings, keeping minutes, etc.[6]

- Some states do not require trusts to make annual filings to the state attorney general (or other designated state representative).[7]

Disadvantages of the trust form:

- Amending the trust instrument may require court approval and notice to the state attorney general. Consequently, it may be difficult for a trust to adapt to changing circumstances over time, such as the resignation of a trustee.[8]

- Some states do not allow trustees to delegate authority on important matters like investment management and grant making. Consequently, trustees may have to assume more direct responsibilities (when compared to corporate directors).[9]

Advantages of the corporate form:

- State laws that indemnify officers and directors generally offer more protection than state laws that indemnify trustees.[10]
- Trustees are generally liable for simple negligence, whereas corporate directors are usually only liable for gross negligence. Corporate directors are protected by the "business judgment rule" which holds that "…decisions by directors made in good faith, with due care, and in the honest belief that the action taken is in the best interest of the corporation are protected from challenge."[11]
- A corporation's governing instruments can be drafted so as to enable the corporation to adapt to changing circumstances, e.g., flexibility built into bylaws can facilitate adding amendments, enlarging the board, etc.[12]

Disadvantage of the corporate form:

State laws relating to a corporation's formation and operation tend to be formal and rigid. These laws require articles of incorporation, bylaws, regular meetings, etc.

Best practice recommendations:

- The corporate form is preferable in almost every case. The corporation's formal and rigid procedures are not necessarily a "disadvantage." In today's climate, where a heightened level of accountability is the norm, all private foundations should hold regular meetings, record minutes, etc. Moreover, the corporate form offers greater flexibility to adopt to changing circumstances. The trust form should only be considered when the private foundation's founder wants to keep the private foundation's mission as immutable as possible.
- The private foundation should employ an attorney to advise the trustees, so that they may ensure they are complying with applicable state law, regardless of the form chosen.

B. FILING FOR TAX-EXEMPT STATUS

Once a private foundation has been organized in trust or corporate form, its tax-exempt status under Section 501(c)(3) of the Internal Revenue Code ("IRC") needs to be secured by filing Form 1023 [Application for Recognition of Exemption]. Attaining tax-exempt status under Section 501(c)(3) is important for two reasons: 1) Donors who itemize will be able to deduct contributions to the private foundation on their federal income tax returns;[13] and 2) Income earned by the private foundation will not be subject to federal or state income tax.[14] Private foundations are subject to tax on unrelated business income, and, in fact, must file Form 990-T if unrelated business income exceeds $1,000.[15] (Although a private foundation's "net investment income" is subject to an excise tax of 1% – 2%, this rate is substantially lower than conventional income tax.) Once the IRS processes and approves the Form 1023, the private foundation receives a recognition letter acknowledging its tax-exempt status. The private foundation must also register as a tax-exempt organization in the state in which it is domiciled.

Best practice recommendations:

- Confirm that the Form 1023 is submitted within the first 15 months of a private foundation's organization. Submitting the Form 1023 during this period ensures that the private foundation's tax-exempt status is retroactive to the date of its organization (versus the date when the IRS receives the Form 1023).[16]
- Confirm that the private foundation files for an employer identification number by submitting Form SS-4 [Application for Employer Identification Number]. This must be done regardless of whether or not the private foundation intends on hiring employees.[17]

- The private foundation's organizing instrument, i.e., the trust or articles of incorporation, needs to include a purpose clause that reflects the private foundation's mission. Oftentimes purpose clauses are drafted in nonspecific language to expedite the tax exemption process and enable the private foundation to pursue a broad range of charitable activities. If the founding donor wants a narrow charitable mission, the purpose clause should be worded accordingly. *If at some later date the private foundation's mission changes, however, the purpose clause will need to be redrafted and resubmitted to the IRS and appropriate state authorities.*

C. CHOOSING THE ASSETS TO ACCEPT

The most common assets used to fund private foundations include cash, appreciated stock, real estate and closely-held business interests. Some assets may be more advantageous than others in the eyes of donors and private foundations.

Considerations for the donor:

- A gift of cash is the simplest funding asset. The donor can deduct up to 30% of his or her adjusted gross income in the taxable year (as opposed to 50% for gifts of cash to public charities), and carry forward any unused portion of the deduction up to five years.[18]

- A gift of appreciated property, such as artwork, real property and interests in a closely-held business, entitles the donor to deduct up to 20% of his or her adjusted gross income in the taxable year (as opposed to 30% for gifts of appreciated property to public charities).[19] The donor can carry forward any unused portion of the deduction up to five years. The value of the donation for deductibility purposes is limited to the *lesser* of the gifted property's fair market value or the donor's cost basis. For example, if a donor funds a private ordinary income property foundation with a residence that originally cost $75,000 and that now has a fair market value of $150,000, the donor is only allowed to deduct the cost basis of $75,000 for income tax purposes.

Important exception: Publicly traded stock that has been owned for more than one year may be deducted at its market value. A donor avoids paying any capital gains on the appreciation. Closely-held stock, real estate and tangible property do not qualify for this exception.[20]

EXAMPLE: *Bill wishes to fund his private foundation with publicly traded stock that he has owned for twenty years. The stock has a fair market value of $500,000, and a basis in Bill's hands of $100,000, and Bill's annual income is $200,000. Given the 20% deductibility limitation on long-term appreciated property, the most Bill can deduct in the year of his gift is $40,000 ($200,000 x 20%). Bill can "carry forward" the deductions for an additional five years, with his maximum combined deductions totaling $240,000 ($40,000 x 6). (Because the stock is publicly traded, Bill's income tax deduction is not limited to his income tax basis in the stock.) Bill decides to contribute $240,000 worth of stock.*

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Considerations for the private foundation:

- A private foundation must exercise particular caution when accepting interests in a closely held business. A private foundation and its disqualified persons, i.e., the donor and the donor's spouse, children, grandchildren ("disqualified persons" are discussed in Section V), are prohibited from owning more than 20% of the voting stock of any corporation. The private foundation is subject to an excise tax if these percentages are exceeded.[21] (The prohibition against retaining excess business holdings is discussed in Section V.)

- Private foundations must obtain certified, independent appraisals of their investment real estate every five years.[22] Given the high cost of appraisals, private foundations should consider avoiding donations of modest parcels of real estate.

D. CHOOSING THE ACCOUNTING METHOD

An accounting method is a set of rules used to determine when and how income and expenses are reported. A private foundation may use either the cash or accrual method as long as the method distinguishes income clearly.[23]

Under the cash method, income is recorded in the tax year received and expenses are recorded in the tax year paid. Under the accrual method, income is recorded in the tax year earned, even though the income may be received in a later year. Similarly, expenses are recorded in the tax year incurred, even though the expenses may be paid in a later year. The simplicity of the cash method makes it the preferred choice of many private foundations in their initial years.[24]

As private foundations mature and begin needing audited statements, it becomes necessary to use the accrual method. Given that the Generally Accepted Accounting Principles (GAAP) recommends the accrual method, accountants rarely issue opinions on financial statements prepared using the cash method.[25]

What to look for on the Form 990-PF:

In the year in which a private foundation switches accounting methods, check that Form 3115 [Application for Change in Accounting Method] is submitted along with the Form 990-PF.[26]

Best practice recommendation:

The Better Business Bureau recommends that 501(c)(3) public charities prepare financial statements in accordance with GAAP when their total annual gross income exceeds $250,000.[27] Private foundations are advised to do the same.

Running the Private Foundation

Federal law requires private foundations to undertake a number of administrative tasks. Failure to do so may subject the private foundation to significant fines. Following are some of the most important tasks:

A. FILING THE FORM 990-PF

The Form 990-PF is the information return that private foundations are required to file annually with the IRS. The Form 990-PF is used to calculate the tax on investment income and lists charitable distributions and activities, the names of trustees and officers, and the grant recipients. The Form 990-PF must be filed by the 15th day of the fifth month following the close of its accounting period, e.g., if a private foundation operates on a calendar year, the Form 990-PF is due on May 15th.[28]

A copy of the annual Form 990-PF must be sent to the attorney general of:[29]

- Each state listed on the Form 990-PF.
- The state where the private foundation's principal office is located.
- The state where the private foundation was incorporated or created.
- Any state that requests it.

Moreover, states in which private foundations do business can have additional filing requirements. "Doing business" includes:[30]

- Soliciting contributions in the state.
- Conducting programs in the state.
- Having employees in the state.
- Maintaining a bank account or owning or renting property in the state.

Best practice recommendation:

- Contact the appropriate officials of all states in which the private foundation is doing business to ascertain each state's specific filing requirements.

What to look for on the Form 990-PF:

- Check the overall appearance of the Form 990-PF for completeness:[31]

  1. All applicable line items should be filled in.
  2. Each question should be answered "Yes," "No," or "N/A" (not available).
  3. Numbers (including a zero when appropriate) should be entered on all total lines.
  4. "None" or "N/A" should be entered if an entire section does not apply.

- If a private foundation invests in securities and makes grants, confirm that the following schedules are attached:[32]

  1. **List of investments:** Refer to Part II [Balance Sheets], lines 7, 10, 11, 13, and 14. Investment assets, e.g., stocks, bonds, land holdings and equipment, must be listed separately and assigned individual end-of-year values. Aggregate totals by investment type are not permitted. (For larger private foundations this list can be many pages long.)
  2. **List of capital gains and losses:** Refer to Part IV [Capital Gains and Losses for Tax on Investment Income]. Each transaction that produced a capital gain or loss must be listed.

3. **List of grants paid and approved:** Refer to Part XV [Supplementary Information], line 3(a) and (b). The following grant information must be disclosed:

– Name and address of the recipient.

– If the recipient is an individual, any relationship to any foundation manager, i.e., an officer, director or trustee, or substantial contributor.

– Foundation status of the recipient, i.e., public charity, private foundation or non-charity. Answering "501(c)(3)" is insufficient, since public charities and private foundations are both classified as 501(c)(3) organizations.

– Purpose of the grant.

– Amount of the grant.

- Review the activities listed in the private foundation's Form 1023 [Application for Recognition of Exemption], Part II, line 1 and confirm that they mirror the activities listed in the Form 990-PF, Part IX-A [Summary of Direct Charitable Activities] and Part XV [Supplementary Information], line 2 (grant information). If the activities do not match, the private foundation is at risk of losing its tax-exempt status.

The president, vice president, treasurer or other corporate officer who is authorized to conduct business on behalf of the private foundation is required to sign the Form 990-PF. If the Form 990-PF is filed for a trust, the authorized trustee or trustees must sign it.[33]

Best practice recommendation:

- Urge the chief executive officer to sign the Form 990-PF. The chief executive officer's signature signals that the private foundation's highest-ranking officer endorses the private foundation's operations and practices.

B. ALLOWING PUBLIC INSPECTION OF THE FORM 990-PF

Private foundations are required to provide photocopies of their three most recent Forms 990-PF and their Form 1023 [Application for Recognition of Exemption] to anyone who requests them in person or in writing. This requirement also applies to all schedules, attachments, supporting documents and amendments. Copies of these documents must be available on a same-day basis for walk-in requests, and within 30 days for mail-in requests. Private foundations may charge a reasonable fee as long as it is limited to the cost of per-page copying and actual postage costs.[34]

These public inspection requirements are waived in part if a private foundation posts its Form 990-PF and Form 1023 on its World Wide Web site. The documents must be easily downloadable and readily available to the general public free of charge. Posting documents on the Internet does not relieve the private foundation of its duty of allowing public inspection by office visitation.[35]

What to look for on Form 990-PF:

- Confirm the accuracy of the response to the notice requirements in Part VII-A [Statements Regarding Activities], lines 13 and 14.

Best practice recommendation:

- Confirm that public inspection procedures are in place, and that employees know how to respond to requests from the public (in person, by telephone, and by regular or electronic mail).

C. SUBSTANTIATING DONOR CONTRIBUTIONS

The Internal Revenue Service applies substantiation requirements for donors, and disclosure requirements for charitable organizations, in connection with charitable contributions. While many private foundations do no engage in fundraising activities, some do solicit contributions, and a foundation may need to be familiar with the tax rules requiring substantiation and disclosure.

A donor can deduct a charitable contribution of $250.00 or more only if the donor has a written acknowledgement from the charitable organization. The written acknowledgement must contain the following information:[36]

- Name of the organization;
- Amount of cash contribution;
- Description (but not value) of non-cash contribution;
- Statement that no goods or services were provided by the organization, if that is the case;
- Description and good faith estimate of the value of goods or services, if any, that the organization provided in return for the contribution; and
- Statement that goods or services, if any, that the organization provided in return for the contribution consisted entirely of intangible religious, if that was the case.

For contributions of cash, check or other monetary gifts, the donor must maintain as a record a bank record or other written communication from the donee organization showing the donee's name and date and amount of contribution.[37]

A private foundation that fails to make the required disclosure for each *quid pro quo* contribution is subject to a penalty of $10 for each failure, not to exceed $5,000 for a particular fundraising event or mailing, unless it can show reasonable cause for not providing the disclosure.[38]

Best practice recommendation:

- Confirm that a contribution substantiation policy is in place that conforms to the criteria outlined above.

What a Private Foundation *Must* Do

A. SATISFY THE MINIMUM DISTRIBUTION AMOUNT

A private foundation must distribute 5% of its investment assets (also known as the "Minimum Investment Return") annually.[39] If a sufficient amount is distributed to charitable organizations, the private foundation will not be subject to the excise tax on "failure to distribute income." (The term "failure to distribute income" is a misnomer, in that the required distribution is based on the value of the private foundation's investment assets and not on its income.)

1. Minimum Investment Return

The Minimum Investment Return in a taxable year refers to 5% of the fair market value of the investment assets for the preceding year *minus* the debt incurred to acquire the investment assets *minus* cash reserves in an amount equal to 1½% of investment assets. Schematically, the equation looks like this:[40]

(Private Foundation – Debt* –
Cash Reserves**) x 5% = Minimum Investment

Investment Assets Return

* Debt refers to any debt incurred to obtain investment assets.

** Cash reserves equal to 1½% of the fair market value of the private foundation's investment assets, even if a smaller cash balance is actually maintained.[41]

Typically, investment assets include stocks, bonds, certificates of deposit and rental properties.[42] Assets used to conduct charitable activities (known as "exempt function assets") are excluded from the Minimum Investment Return. Some of the most common exempt function assets include:[43]

- The building in which a private foundation maintains its office.
- Furniture, equipment and supplies used by employees for a private foundation's charitable projects.
- The exempt function portion of dual-use property. If a private foundation owns real estate in which it conducts both investment and charitable activities, the space must be allocated based on the job functions of the persons using the space. Following is an example of an office building allocation:

Investment department (investment asset)	2,000 square feet	20%
Program offices (exempt function asset)	8,000 square feet	80%
	10,000 square feet	100%

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In this example, 20% of the building's value would be treated as an investment asset.

Calculating the Minimum Investment Return requires distinguishing investment assets from exempt function assets. If an exempt function asset is identified mistakenly as an investment asset, 5% of its value must be distributed annually for charitable purposes.

2. Minimum Distribution Requirements

A private foundation must distribute a minimum distribution amount annually. The minimum distribution amount is equal to the Minimum Investment Return in the current year *minus* any taxes imposed in the current year *plus* any qualifying distributions that were returned from the prior year. Schematically, the calculation looks like this:[44]

Minimum Investment Return	– Taxes + Returned Qualifying Distributions	= Minimum Distribution Amount

The minimum distribution amount must be satisfied by making sufficient qualifying distributions. If qualified distributions do not cover the entire minimum distribution amount, the private foundation is subject to an excise tax on the "uncovered amount," known as the "undistributed amount."

3. Qualifying Distributions

A qualifying distribution refers to cash or property paid: (1) in furtherance of a private foundation's exempt purposes; or (2) to obtain an asset to be used directly in achieving the private foundation's exempt purposes.[45]

The most common qualifying distributions include:[46]

- Grants made to 501(c)(3) public charities.
- Payments of reasonable and necessary administrative expenses incurred in conducting a private foundation's charitable purposes. Investment management fees are not included.
- Payments to purchase assets used by the private foundation in carrying out its charitable purposes.
- Costs of all direct charitable activities, e.g., operating a library, maintaining a historical site, etc.
- Grants made to non-charitable organizations or individuals for charitable purposes, subject to expenditure responsibility. [Expenditure responsibility is discussed in Section VI.]
- Grants to other private foundations as long as three conditions are met:[47]
  - The recipient private foundation distributes the grant funds for a charitable purpose by the tax year-end of the succeeding year in which the grant funds are received; and
  - The recipient private foundation fulfills its own distributable amount requirement which is separate and apart from the grant funds received from the donor private foundation; and
  - The donor private foundation obtains adequate records and other evidence reflecting that the recipient private foundation has made qualifying distributions with the grant funds. The records must show the names and addresses of the recipients of the qualifying distributions, and the amount received by each.

EXAMPLE: *The Smith Foundation and the Jones Foundation are both private foundations, and both are on a calendar year. The Smith Foundation made a $30,000 qualifying distribution to the Jones Foundation in 2008. The Jones Foundation must distribute the entire $30,000 by the end of 2009. Moreover, the Jones Foundation cannot count the $30,000 against its own distributable amount that it is obligated to pay out in 2009.*

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What to look for on the Form 990-PF:

- Obtain a copy of the private foundation's Form 990-PF for the previous year. Check Part XIII [Undistributed Income], line 6(f) [undistributed income for current tax year], and confirm that any undistributed amount listed has been distributed during the current tax year.[48]

- Confirm that Part I, column (d) [Disbursements for charitable purposes] is completed using the cash method of accounting.[49] All of the amounts entered on Part I, column (d) are qualified distributions that were paid out by the end of the taxable year and qualify toward meeting the 5% minimum distribution requirement. Amounts approved for future payment must not be included in column (d).

- Confirm that Part I, column (d) [Disbursements for charitable purposes] does not include any amounts that are listed in column (b) [Net investment income]. Amounts in column (b) represent expenses incurred in managing the private foundation's investments. None of these expenses qualify toward meeting the 5% minimum distribution requirement.

4. Distribution Requirements for Private Foundations Less Than Five Years Old

A private foundation that is less than five years old can take advantage of a special distribution schedule if it can demonstrate that a specific project is better served by accumulating funds versus immediate payment of funds. The private foundation is treated as having met the minimum distribution amount if it adheres to the following payout schedule:

- Distributes 20% of the minimum investment return in the first taxable year.

- Distributes 40% of the minimum investment return in the second taxable year.

- Distributes 60% of the minimum investment return in the third taxable year.

- Distributes 80% of the minimum investment return in the fourth taxable year.

- Distributes 100% of the minimum investment return in the fifth taxable year.

The determination of whether the private foundation met the minimum distribution amount is made at the end of the fourth year.[50]

EXAMPLE: *A private foundation was created four years ago. It has $980,000 worth of securities and $20,000 worth of office furnishings (investment assets). The private foundation's minimum investment return has been $100,000 annually over the past four years [5% x ($980,000 + $20,000) = $100,000]. The private foundation's aggregate minimum distribution amount is $200,000:*

20% of $100,000	= $20,000
40% of $100,000	= $40,000
60% of $100,000	= $60,000
80% of $100,000	= $80,000
	$200,000

As long as the private foundation has made at least $200,000 worth of qualifying distributions over the past four years, it has met the minimum distribution amount and will not be subject to excise tax on undistributed income.

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B. PAY AN EXCISE TAX ON INVESTMENT INCOME

A private foundation must pay an annual excise tax on its net investment income.[51] The standard rate of 2% may be reduced to 1% if certain conditions are met. Net investment income is the sum of gross investment income and net capital gain *minus* allowable deductions.[52] Schematically, the calculation looks like this:

Gross Investment Income	+ Net Capital – Allowable Deductions Gain	= Net Investment Income

1. Gross Investment Income

"Gross Investment Income" refers to income derived from assets held for investment purposes.[53] Examples include:

- Interest earned on money market accounts, bank savings, certificates of deposit, corporate bonds, etc.
- Dividends from stocks, mutual funds, etc.
- Rental income.

2. Net Capital Gain

"Net Capital Gain" is the total of realized capital gains or losses from the sale of property held for investment purposes.[54] On the other hand, the sale of property used for exempt purposes results in nontaxable gains or losses. If property is used for both investment purposes *and* exempt activities, e.g., part of the building was used by paying tenants (investment purposes) and part of the building was used by administrative staff (exempt activities), its sale will result in *pro rata* taxable and nontaxable gain or loss.[55] Capital losses are deductible only to the extent of capital gains realized in the same year. Excess capital losses may not be used to offset gains in succeeding years.

Appreciated property that a private foundation receives as a bequest from a donor's estate is entitled to a "step up" in tax basis to its value at the time of the donor's death. In contrast, appreciated property that a private foundation receives as a gift during the donor's lifetime retains the donor's "carryover basis." In other words, a private foundation is not allowed to "step up" the carryover basis of the gift to the gift's fair market value.[56]

EXAMPLE: *On June 1, 2009, a donor makes a gift of real property with a fair market value of $100,000. The donor had purchased the property twenty years ago for $20,000. On June 2, 2009, the private foundation sells the property for $95,000. The private foundation is subject to a capital gain of $75,000 (sale price [$95,000] minus carryover basis [$20,000]).*

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3. Deductions

Deductions include all ordinary and necessary investment expenses paid or incurred for the production or collection of income.[57] Typically, some of the most common investment expenses include:

- Compensation of financial officers.
- Legal and accounting fees.
- Office rent.

Expenses that stem from both investment and exempt activities must be allocated. For example, if employees engage in investment and exempt activities, their compensation must be allocated between investment activities *and* exempt activities. The "investment activity" portion of their compensation can be deducted from gross investment income, whereas the exempt activity portion of their compensation cannot be deducted from gross investment income. Similarly, charitable distributions, administrative expenses associated with exempt activities and the costs associated with purchasing exempt function assets cannot be deducted against gross investment income.[58]

EXAMPLE: *A railroad museum is a private foundation. The museum's assets include stock worth $100,000. The stock generates $5,000 worth of income annually, and brokerage fees total $1,000 annually. The museum owns two pieces of property—a garage used for displaying antique trains and a commercial parking lot. The parking lot generates $8,000 worth of income annually. The museum decides to sell the garage and the parking lot. The garage generates a realized capital gain of $20,000. The parking lot generates a realized capital gain of $150,000. In the year in which these properties are sold, the museum's net investment income totals $154,000 [income from the stock ($5,000) plus realized capital gain from the sale of the parking lot ($150,000) minus brokerage fees ($1,000) = $154,000]. In light of the fact that the garage was devoted to the museum's exempt activity, the realized capital gain from its sale is not included in the net investment income.*

4. Qualifying for the 1% Tax Rate

A private foundation qualifies for the 1% tax rate in any year in which its qualifying distributions exceed the average percentage of its distributions over the five preceding taxable years. Following is a step-by-step formula for determining whether a private foundation can take advantage of the 1% rate.[59]

First, for each of the past five years, identify each year's qualifying distributions and investment assets. Calculate the distribution ratios by dividing each year's qualifying distributions by each year's investment assets. Below is an example.

	QUALIFYING DISTRIBUTIONS	INVESTMENT ASSETS	DISTRIBUTION RATIO
2009	$2,000,000	$40,000,000	5.2%
2008	$1,824,000	$38,000,000	4.8%
2007	$2,200,000	$44,000,000	5%
2006	$1,840,000	$40,000,000	4.6%
2005	$1,944,000	$36,000,000	5.4%

Second, calculate the five-year average distribution ratio. In the example, the five-year average distribution rate is 5%.

[5.2% + 4.8% + 5% + 4.6% + 5.4% / 5 = 5%]

Third, multiply the five-year average distribution ratio by the current year's investment assets. Then add 1% of the current year's net investment income to arrive at the baseline number. Assuming that the current year's investment assets total $42,000,000 and the current year's investment income is $40,000, then the baseline number is $2,140,000.

(5% x $42,000,000) + ($40,000 x 1%) = $2,100,400

If the current year's qualifying distributions total $2,100,400 or more, then the private foundation qualifies for the 1% tax rate.

This case study is provided for illustrative purposes only. Past performance is no guarantee of future results. The information has been obtained from sources we believe to be reliable, but we cannot guarantee its accuracy or completeness. These strategies do not guarantee a profit or protect against loss and may not be suitable for all investors. Each customer's specific situation, goals, and results may differ.

What to look for on the Form 990-PF:

- Check if the box in Part VI [Excise Tax Based on Investment Income], line 1(b) is marked off. If it is, the private foundation is paying 1% tax on net investment income. If the private foundation is paying 2%, find out if it is feasible to reduce the rate to 1%.

- Check the expense components in Part I [Analysis of Revenue and Expenses], i.e., compensation and benefits [lines 13, 14 and 15], operating expenses [line 16–23] and contributions and grants paid [line 25]. Keep in mind that the IRS may compare the amount spent on charitable activities with the amount spent on operating and administrative expenses. As a rule, the Better Business Bureau recommends the following for public charities: 1) at least half of a charity's total income should be spent on programs; and 2) no more than half of a charity's total income should be spent on administrative and fund raising costs.[60] Private foundations should follow the same recommendation.

- Check the "unrelated business" figure in Part XVI-A [Analysis of Income-Producing Activities]. A lot of unrelated business income creates the impression that the private foundation is more focused on its business activities than on its exempt activities. If this is the case, the private foundation's tax-exempt status could be in jeopardy.[61]

Best practice recommendations:

- Distinguishing investment expenses from exempt activity expenses is important because investment expenses reduce net investment income. Confirm that both types of expenses are tracked separately, and that the results are well-documented in case of an IRS audit.

- The interest and dividends generated from a private foundation's investment portfolio may be insufficient to meet the distribution requirement. Consequently, private foundations sometimes raise cash by selling investment assets. The sale, in turn, might trigger realized capital gains that are subject to the excise tax on investment income. A private foundation can minimize its tax on net investment income by making payouts to charities "in kind," or, in other words, by distributing securities (or other property) to grantees *instead* of selling the securities and distributing cash. Distributing securities is not treated as a sale for excise tax purposes. Since the grantee is responsible for paying the commission on the sale of the securities under this scenario, a private foundation might want to increase the number of donated securities to make up the amount of the sales commission.[62]

- In today's heightened level of accountability, consider identifying expenses attributable to direct charitable activity as a "subset" of the administrative expenses. For example, a nonprofit soup kitchen might segregate expenses associated with food, kitchen appliances, dishes and furniture from other overhead expenses not attributable directly to charitable activities. This can be done by placing an asterisk next to Part I, line 24 [Total operating and administrative expenses], and—at the bottom of the page—inserting an asterisk next to a comment stating that total administrative costs include expenses attributable to direct charitable activities which are listed separately in Part IX-A [Summary of Direct Charitable Activities]. Another option is to place an asterisk next to line 26 [Total expenses and disbursements], and reference an attachment that describes all expenses and disbursements in detail, highlighting the costs attributable to direct charitable activities.[63]

What a Private Foundation *Must Not* Do

Congress, in passing the Tax Reform Act of 1969, acted to address the perception that private foundations were engaging in non-charitable activities that benefited officers, trustees, and contributors. As a consequence, private foundations may not do the following:

A. ENGAGE IN SELF-DEALING

Except for a limited number of exceptions, a private foundation must not engage in self-dealing by conducting transactions with "disqualified persons."[64] "Disqualified persons" include:[65]

1. **All substantial contributors.** A "substantial" contributor is any person who contributes or bequeaths an aggregate amount in excess of $5,000 to the private foundation, if such amount is more than 2% of the total contributions and bequests received by the private foundation before the close of its taxable year in which the contribution or bequest is received.[66]

2. **All foundation managers.** A "foundation manager" is any person who is an officer, director, or trustee of a private foundation, as well as employees who have been given powers or responsibilities similar to those of officers, directors or trustees.[67]

3. **An owner of more than 20 percent of:** 1) the total combined voting power of a corporation; 2) the profits interest of a partnership, or 3) the beneficial interest of a trust or unincorporated enterprise that is a substantial contributor to the private foundation.[68]

4. **A member of the family of any individual described in paragraphs 1, 2 and 3.** A "member of the family" is defined as an individual's spouse, parents, children, grandchildren and great grandchildren and the spouses of children, grandchildren and great grandchildren.[69] Disqualified persons do *not* include an individual's brothers, sisters and their descendents.

5. **All corporations, partnerships, trusts and estates in which persons described in paragraphs 1, 2, 3 and 4 own more than 35 percent** of the total combined voting power, profits interest or beneficial interest.[70]

Most transactions between private foundations and disqualified persons are prohibited and subject to an excise tax, regardless of subjective factors such as the reasonableness of the amounts or whether the transaction benefits the private foundation. Examples include:

- Sale or leasing of property between a private foundation and a disqualified person.[71] A disqualified person is *not* permitted to sell property to a private foundation, even if the price is substantially below the property's fair market value; nor is a disqualified person permitted to lease office space to a private foundation, even if the rent is substantially below fair market value. However, a disqualified person *may* provide a private foundation with free office space.

- Furnishing of goods, services or facilities between a private foundation and a disqualified person.[72] A disqualified person *may* furnish goods, services or facilities if done without charge. A private foundation *may* furnish goods, services or facilities to a disqualified person if done so on terms no more favorable than those on which such goods, services or facilities are made available to the general public.[73]

- Lending money or other extension of credit between a private foundation and a disqualified person.[74] However, a disqualified person may lend money to a private foundation if the loan is without interest or other charge.[75] Moreover, if a private foundation makes a cash advance to a foundation manager or employee to cover anticipated out-of-pocket expenses, it is not an act of self-dealing if the advance is reasonable. An advance ordinarily is considered reasonable if it is not more than $500.[76]

- Transferring real or personal property by a disqualified person to a private foundation if the property is subject to a mortgage or similar lien.[77]

- Payment of compensation by a private foundation to a disqualified person.[78] **Important exception:** Disqualified persons *may* receive compensation for personal services that are deemed necessary to carrying out the exempt purpose of the private foundation as long as the compensation is not excessive.[79] The "reasonableness" of compensation is evaluated by determining how much a comparable enterprise would pay for comparable services. "Personal services" generally include legal services, investment services, banking services and accounting services.[80]

What to look for on the Form 990-PF:

- Review the compensation reported in Part I [Analysis of Revenue and Expenses], lines 13–16 and Part VIII [Information About Officer, Directors, Trustees, Foundation Manager, Highly Paid Employees, and Contractors]. Look out for numbers that seem unusually high.
- Review the average hours per week entered in Part VIII, line 1 column (b) [Title, and average hours per week devoted to position]. An estimate of the average hours per week devoted to the position is required. Phrases such as "as needed" or "as required" are unacceptable.[81] Keep in mind that the IRS might calculate the hourly wage by dividing the yearly compensation by the number of hours worked per week. Confirm that the hourly wage seems reasonable.

Best practice recommendations:

- When setting and evaluating salaries, use the Council on Foundations' *Grantmakers Salary and Benefits Reports* as a guide. This resource lists the average compensation for officers, directors and other key staff in different regions of the country. Moreover, review the Forms 990-PF of similarly sized private foundations with comparable job positions. Forms 990-PF are posted on GuideStar's website, www.guidestar.org.

- The Form 990-PF instructions suggest attaching a description of a disqualified person's entire compensation.[82] Taking this extra step might clarify that no self-dealing occurred.

- If the private foundation intends on compensating a disqualified person for a service outside the scope of legal services, investment services, banking services or accounting services, then it should consider obtaining a Private Letter Ruling from the IRS to confirm that payment for the contemplated service is not an act of self-dealing.

- A private foundation should not pay the travel expenses of a disqualified person's spouse unless the expenses constitute part of the disqualified person's compensation or unless the spouse serves the private foundation in some official capacity.

- A private foundation should not purchase charity tickets on behalf of disqualified persons. Such tickets constitute a private benefit to the attendee, even if he or she pays for the portion of the cost representing the benefit, e.g., the dinner or entertainment. In other words, a disqualified person cannot "split" the cost of a charity ticket with the private foundation.

- It is common for a private foundation to share space with the family office. In such cases, the family office cannot accept rent from the private foundation, even as reimbursement. If the private foundation and the family office rent space from an owner who is not a disqualified person, the private foundation and the family office should pay rent separately and directly to the owner. Moreover, if the family office is not donating its telephone line to the private foundation, the private foundation should pay the telephone company separately and directly. A private foundation, by reimbursing a family office for use of a telephone line, has engaged in self-dealing.

B. JEOPARDIZING INVESTMENTS

A private foundation, in order to not incur an excise tax, *must not* invest any amount in such a manner that would jeopardize it from carrying out its exempt purposes.[83] The existence of jeopardy is determined on an investment-by-investment basis, and taking into account the private foundation's entire portfolio. Judging whether or not jeopardy exists is based on the facts available at the time the investment is made, and not on the basis of hindsight.[84]

Foundation managers can look to the Uniform Management of Institutional Funds Act (UMIFA) and the Uniform Prudent Investor Act (UPIA) for guidance. UMIFA and UPIA set forth standards for prudent management of investment assets. UMIFA, for example, requires that consideration be given to the long- and short-term needs of the institution in carrying out its mission, the anticipated need to make distributions and to preserve capital, the expected total return on its investments, and the possible effect of inflation or deflation.[85]

Similarly, UPIA dictates that investment decisions "… must be evaluated not in isolation but in the context of the trust portfolio as a whole and as part of an overall investment strategy."[86]

Based on UMIFA and UPIA, maintaining all of a private foundation's assets in certificates of deposit might be a jeopardizing situation. On the other hand, investing a portion of the portfolio in "risky" investments such as hedge funds might be entirely appropriate. It is interesting to note, in fact, that alternative investments are playing an increasingly important role in private foundation portfolios. One analyst, for example, knows of cases in which hedge funds-of-funds constitute between 10% to 15% of the total assets of family foundations with less than $100 million in assets.[87]

What to look for on the Form 990-PF:

- Review the investments listed in Part II, 10–13 [Investments — U.S. and state government obligations, corporate stock…other]. Although no category of investment is treated as a violation *per se*, the following investments "require close scrutiny:"[88] 1) trading securities on margin; 2) trading in commodity futures; 3) investing in working interests in oil and gas wells; 4) buying "puts," "calls" and "straddles;" 5) buying warrants; and 6) selling short.

In 1998, the IRS expanded this list to include:[89] 1) investments in "junk" bonds; 2) risk arbitrage; 3) hedge funds; 4) derivatives; 5) distressed real estate; and 6) international equities in third world countries, plus others.

Finally, guarantees or collateralizations are forms of investment activity that also deserve close scrutiny.

- Confirm the accuracy of the responses entered in Part VII-B, lines 4(a) and (b), [Did the organization invest during the year any amount in a manner that would jeopardize its charitable purposes?].

Best practice recommendations:

- If the private foundation contemplates holding an investment or engaging in an investment strategy that requires "careful scrutiny," obtain a written memo from a qualified investment counselor that confirms the appropriateness of the investment or investment strategy.[90]

Confirm that the foundation managers are familiar with UMIFA and UPIA, and are aware of the range of fees associated with different investments. If the foundation managers lack this knowledge, the private foundation should hire a qualified investment counselor.

C. RETAIN EXCESS BUSINESS HOLDINGS

One of the Internal Revenue Code's public policy objectives is to deter private foundations from controlling for-profit businesses for any extended length of time. Consequently, a private foundation, in order to avoid incurring an excise tax, *must not* retain excess business holdings.[91] In general, a private foundation and all of its disqualified persons together are prohibited from owning more than 20% of the total voting stock of the same corporation. If an unrelated party, i.e., someone who is not a disqualified person, has effective control of the corporation, a private foundation and all of its disqualified persons together may own up to 35% of the total voting stock of the same corporation. A 2% *de minimus* rule allows a private foundation to own not more than 2% of a corporation's voting stock and not more than 2% in value of all of its outstanding shares of all classes of stock (no matter how much its disqualified persons own).[92]

A private foundation that acquires excess business holdings, other than as a result of a purchase, will not be subject to an excise tax if it disposes of the excess business holdings within 90 days from the date on which it knows, or has reason to know, of the event that caused it to have the excess holdings. The 90-day disposition period applies when a disqualified person acquires additional holdings.[93] For example, when a private foundation owns 15% of the voting stock of a corporation, all disqualified persons own 20% of the same stock and an unrelated party has effective control of the corporation, if a disqualified person subsequently purchases an additional 10% of the corporation's stock, the private foundation has 90 days in which to dispose of excess stock from the date on which it knew, or had reason to know, of the disqualified person's purchase.

If a private foundation acquires excess business holdings through a gift or bequest, it has five years in which to dispose of them.[94] If a private foundation is unable to dispose of the excess business holdings within the five-year period, the IRS can grant a private foundation another five-year extension if the private foundation establishes the following:[95]

1. Diligent efforts to dispose of such holdings were made within the initial five-year period;
2. Disposition within the initial five-year period was not possible (except at a price substantially below fair market value) by reason of the size, complexity or diversity of such holdings;
3. The private foundation submitted to the IRS a plan for disposing of all excess business holdings, as well as to the state attorney general or other appropriate state official; and
4. The IRS determines that such a plan can reasonably be expected to be carried out before the close of the extension period.

What to look for on Form 990-PF:

Confirm the accuracy of the response entered in Part VII-B, 3(a) and (b), [Did the organization hold more than a 2% direct or indirect interest in any business enterprise at any time during the year?].

Best practice recommendation:

If the private foundation has excess business holdings, confirm that steps are being taken to dispose of them expeditiously.

D. TAXABLE EXPENDITURES

Another public policy objective of the Internal Revenue Code is to prevent private foundations from supporting noncharitable causes. Consequently, a private foundation, in order to avoid incurring an excise tax, *must not* undertake the following transactions—known as taxable expenditures.[96] Moreover, grants that are deemed to be taxable expenditures do not count toward the private foundation's minimum distribution requirements.

1. Lobbying

A private foundation *must not* carry on propaganda or otherwise attempt to influence legislation.[97] The term "taxable expenditure" in this context applies to any amount paid or incurred by a private foundation for:

1. Any attempt to influence legislation by trying to affect the opinion of the general public;[98] and
2. Any attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of legislation.[99]

However, a private foundation *may* pursue legislative reform under certain conditions. The term "taxable expenditure" does *not* apply if the amount paid or incurred falls within one of the following exceptions:[100]

1. Conducting nonpartisan analysis, study, or research and making the results available to the general public and government officials.
2. Providing technical advice or assistance to a governmental body in response to a written request from that governmental body.

3. Appearing before, or communication with, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions.

4. Expenditures for examinations and discussions of broad social, economic and similar problems, even if the problems are of the type that the government would be expected to deal with ultimately. The examinations and discussions must not address the merits of a specific legislative proposal.

5. Grants to public charities that conduct legislative lobbying as long as the grant is not earmarked for the purpose of influencing legislation.

2. Voter Registration Drives

A private foundation *must not* influence the outcome of any election, or carry on, either directly or indirectly, any voter registration drive, with exceptions.[101] The term "taxable expenditure" in this context applies to any amount paid or incurred to conduct activities such as publishing or distributing statements on behalf of or in opposition to a candidate; paying the salaries or expenses of campaign workers; and conducting or paying the expenses of conducting a voter registration drive limited to the geographic areas covered by the campaign.[102]

A private foundation *may* engage in voter registration drives under certain conditions. The term "taxable expenditure" is not applicable to amounts paid or incurred for such endeavors if all of the following criteria are met:[103]

- The activities of the recipient organization are nonpartisan; are not confined to one specific election period; and are carried on in five or more states;
- The recipient organization spends at least 85% of its income directly on charitable activities in furtherance of its tax exempt purpose;
- The recipient organization receives at least 85% of its support (other than gross investment income) from exempt organizations, the general public, governmental units, or any combination of these; it does not receive more than 25% of its support (other than gross investment income) from any one exempt organization; and it does not receive more than 50% of its support from gross investment income; and
- Contributions to the recipient organization for voter registration drives are not earmarked for specified states or localities; nor are they earmarked for only one specific election period.

What to look for on Form 990-PF:

If the private foundation lobbied or attempted to influence the outcome of a public election during the tax year, confirm that the responses entered in Part VII-A [Statements Regarding Activities], lines 1(a) and (b) are answered in the affirmative, and that a detailed description is attached.

3. Scholarship Grants

A private foundation *must not* award grants to individuals for travel, study or other similar purposes.[104] Such grants are considered taxable expenditures *unless* the following conditions are met:[105]

1. The grant is awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the IRS; and
2. It is shown, to the satisfaction of the IRS, that one of the following requirements is met:[106]

- The grant is a scholarship or fellowship that is to be used for study at an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance. For these purposes, there is no requirement that the grant recipients be limited to degree candidates, nor must the grant be limited to tuition, fees and course-required books, supplies and equipment. A recipient may use grant funds for room, board, travel research, clerical help, or equipment, that are incidental to the purposes of the scholarship or fellowship grant.
- The grant represents a prize or award and the recipient is selected from the general public.
- The grant's purpose is to achieve a specific objective, produce a report or similar product or improve or enhance a literary, artistic, musical, scientific, teaching or similar capacity, skill, or talent of the grantee.

Requests for approval of grant-making procedures should be sent to the District Director of the nearest IRS office. If, by the 45th day after a request has been submitted, the private foundation has *not* been notified by the IRS that the procedures are unacceptable, the grant-making procedures may be considered approved from the date of submission.[107]

A private foundation *may* distribute a grant to a public charity that makes awards and scholarships to qualified individuals. In such a case, the private foundation does not need to seek advance approval from the IRS as long as the public charity controls the process of selecting the scholarship recipients.[108]

Grants to individuals for purposes *other than* to travel, study or other similar purposes do not need advance IRS approval. In one case, grants and interest-free loans were not considered taxable expenditures when they were offered through a private foundation's hardship program to pay for extraordinary medical, funeral and other expenses arising from natural disasters like hurricanes and fires.[109] Other examples of grants not constituting taxable expenditures include grants that are unconditional and unrestricted, such as one that was made to fund an award in recognition of past humanitarian accomplishments with no strings attached on how the award had to be spent.[110]

What Private Foundation *May* Do by Exercising Expenditure Responsibility

A private foundation must assume a higher duty of care—known as expenditure responsibility – if it wants to make qualifying distributions to organizations other than traditional 501(c)(3) public charities.

A. GRANTS TO DOMESTIC NON-501(C)(3) PUBLIC ORGANIZATIONS

Non-501(c)(3) public organizations include private foundations, Section 501(c) organizations with subsections other than (3), e.g., chambers of commerce and trade organizations, and foreign organizations. In such cases, the private foundation is required to take the following steps to provide assurance that the charitable distributions will be used for the intended charitable purposes:[111]

1. Conduct a pre-grant inquiry into the grantee's identity, past history and activities to ensure that the grantee is capable of using the grant for the purposes for which it is made.

2. Execute a grant agreement which includes provisions that the grantee will do the following:

- Repay any amount not used for the purposes of the grant;
- Submit full and complete annual reports to the grantor foundation on the manner in which the funds are spent and their progress made in accomplishing the purposes of the grant;
- Keep records of receipts and expenditures and to make its books and records available to the grantor at reasonable times; and
- Not use any of the funds to influence legislation, to influence the outcome of elections, to carry on voter registration drives, to make grants to individuals or other organizations, or to undertake any nonexempt activity, when such use of the funds would be a taxable expenditure if made directly by the foundation.

3. Report and summarize the status of the grant on the private foundation's Form 990-PF.

What to look for on the Form 990-PF:

- Confirm that a report on each expenditure responsibility grant that remains unspent by the grantee at *any* time during the year is attached to the Form 990-PF. Check that the expenditure responsibility report contains the following:[112]

- The name and address of the grantee.
- The date and amount of the grant.
- The purpose of the grant.
- The amounts spent by the grantee.
- Whether, to the knowledge of the grantor foundation, the grantee has diverted any funds from the purpose of the grant.
- The date 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 foundation.

Best practice recommendation:

- Ask the grantee organization to prepare the expenditure responsibility report, using the format outlined above.

B. GRANTS TO FOREIGN ORGANIZATIONS

A private foundation can make qualifying distributions to foreign organizations as long as the purpose and use of the distributions are charitable. If a private foundation wants to make a grant to a foreign organization that is not recognized by the IRS as a 501(c)(3) public charity, then it must take one of the following two steps: 1) conduct an equivalency determination that the foreign organization is the "equivalent" of a U.S. public charity; or 2) exercise expenditure responsibility over the grant money to confirm that it is used for charitable purposes.[113]

If a private foundation chooses to conduct an "equivalency determination" of the foreign organization, it must collect the following documents:[114]

1. The foreign organization's governing documents;
2. A detailed description of the foreign organization's purposes and its past and proposed activities;
3. The foreign organization's dissolution provisions, either contained in the applicable law or in the governing documents;
4. The foreign organization's restrictions on private benefit, non-charitable activities, lobbying, and participation in political campaigns; and
5. The foreign organization's financial records.

If these documents are not written in English, they must be translated and made available in English.

Alternatively, a foundation may choose to exercise expenditure responsibility over the grant money by undertaking the three "expenditure responsibility steps" listed on page 22 of this manual. If the foreign organization proves to be the equivalent of a U.S. private foundation (and not a U.S. public charity), then the private foundation has no choice but to exercise expenditure responsibility over the grant money.[115]

Best practice recommendation:

- The "expenditure responsibility" option is generally less preferable than the "equivalency determination" option because it requires continuous reporting and follow-up on the grant money. However, the "equivalency determination" is not always feasible due to the difficulty of assembling the required documents, obtaining English translations, and gathering the financial records necessary to prove that the foreign organization is the equivalent of a U.S. public charity and not a U.S. private foundation.

Final Suggestions in the Wake of the Sarbanes-Oxley Act

The Sarbanes-Oxley Act (the "Act") of 2002 was enacted in response to a number of corporate and accounting scandals in 2000 and 2001. The Act imposed additional oversight responsibilities on board members of publicly traded companies in the areas of governance, ethics, business practice and accountability. Some state attorneys general are proposing to make the Act applicable to nonprofit organizations. Consequently, private foundations are well advised to measure their governance procedures against the procedures and policies mandated by the Act.

Best practice recommendations:

In wake of the Act, at a minimum private foundations should institute the following policies:

- **Conflicts of interest policy:** The personal and business interests of disqualified persons can subject private foundations and disqualified persons to significant excise taxes, e.g., self-dealing violations and excess business holding violations. The conflict of interest policy should include the following: 1) Require disqualified persons to disclose their ownership interests in companies doing business with the private foundation; 2) Provide that any potential conflicts of interest are to be ruled upon by non-conflicted trustees; and 3) Direct trustees to recuse themselves from voting on matters that are related to their real or apparent conflicts of interest.

- **Audit oversight policy.** The Act contains provisions designed to ensure the autonomy of auditors. When trustees hire and oversee auditors, they should do so pursuant to a policy which requires that auditors not have any associations with the private foundation or disqualified persons that would compromise their independence.

- **Whistle-blower protection policy.** The Act requires for-profit *and* non-profit organizations to have confidential and anonymous complaint mechanisms in place to protect employees who express concerns about accounting and auditing irregularities. The private foundation should institute a whistle-blower policy that creates a confidential and anonymous mechanism to employees to report any inappropriateness with respect to the foundation's management. Individuals who retaliate against whistle-blowers are subject to criminal penalties.[116]

Conclusion

The private foundation rules are numerous and complex, and they are not intuitive. Trustees need to master these rules in order in order to fulfill their fiduciary responsibilities. The Form 990-PF is a useful tool in evaluating how well the rules are being followed. Other useful tools include educational programs and consulting seminars provided by investment professionals and others who serve the tax-exempt market. If a private foundation incorporates these rules into its operating procedures, it may be able to avoid excise taxes and stay clear of situations that might jeopardize its tax-exempt status.

1 Instructions for Form 990-PF, 2003, p. 28.

2 The term "trustees" includes corporate directors. A private foundation can be organized as a trust with a board of trustees or as a nonprofit corporation with a board of directors. See The Trustee Notebook, National Center for Family Philanthropy, 1999, p. vi.

3 Internal Revenue Code ("IRC") § 501(c)(3).

4 IRC § 509(a).

5 Edie, John, "First Steps in Starting a Foundation," John Edie, Council on Foundations, 1997, p. 51.

6 Ibid, p. 52.

7 Ibid.

8 Ibid.

9 Ibid.

10 "First Steps in Starting a Foundation," Council on Foundations, 1997, p. 53.

11 Sparks II, W. Donald, et al, "The Benefits of Establishing a Private Foundation in Delaware," Private Foundations, March 2001, p. 112.

12 Edie, John, "First Steps in Starting a Foundation," Council on Foundations, 1997, p. 52.

13 170 (i)(1).

14 501(a).

15 2004 Instructions for Form 990 and Form 990-EZ, Internal Revenue Services, p. 28.

16 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 8.

17 "Employer Identification Number," Internal Revenue Service IRS.gov, p. 1.

18 IRC § 170(b)(1)(B).

19 IRC § 170(b)(1) (D)(i).

20 IRC § 170(e)(1)(B)(ii).

21 IRC § 4943(b)(2).

22 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 23.

23 "General Instructions for Form 990-PF," Internal Revenue Service, (2004), p. 5.

24 Blazek, Jody, "Issues Facing Organizations Preparing the 990 Forms," Taxation of Exempts, May/June 2004, p. 264.

25 Ibid.

26 "Instructions for Form 3115," Internal Revenue Service, p. 1.

27 "Standards for Charity Accountability," BBB Wise Giving Alliance, 2003, p. 3.

28 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 9.

29 Ibid, p. 10.

30 "2004 Instructions for Form 990-PF," Internal Revenue Service, p. 4.

31 Ibid, p. 2.

32 "What You Should Know Before Signing Your Organization's Form 990-PF," Pricewaterhouse Coopers, April 2004, pp. 5–6.

33 Internal Revenue Service, "Specific Instructions for Form 990-PF (2004)," p. 45.

34 "Instructions for Form 990 and Form 990-EZ," Internal Revenue Service IRS.gov, pp. 26–27.

35 Ibid, pp. 31–32.

36 IRS Publication 1771. Charitable Contributions: Substantiation and Disclosure Requirements, www.irs.gov, 2008, p. 3.

37 Ibid.

38 Ibid, p. 11

39 IRC § 4942(e).

40 IRC § 4942(f)(1)(A); Blazek, Jody, "Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures," 1999, p. 270–271.

41 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 23.

42 Ibid., p. 22.

43 Blazek, Jody, "Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures," 1999,r p. 272.

44 Ibid., pp. 277–278.

45 IRC § 4942(g)(1).

46 Ibid.

47 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 25.

48 Internal Revenue Service, "General Instructions for Form 990-PF (2004)," p. 25.

49 Ibid., p. 5.

50 IRC § 4942(g)(2)(B)(ii) (III); Blazek, Jody, Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures, 1999 p. 284.

51 IRC § 4940(a).

52 IRC § 4940(c)(1).

53 IRC § 4940(c)(2).

54 IRC § 4940(c)(4)(A).

55 Priv. Let. Rul. 9320054; Blazek, Jody, "Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures," 1999 p. 229.

56 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," pp. 13–14.

57 IRC § 4940(c)(3)(A).

58 IRS Publication 578, "Tax Information for Private Foundations and Foundation Managers," p. 13.

59 Blazek, Jody, "Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures," 1999, pp. 235–236.

60 "Tips on Charitable Giving," Council of Better Business Bureaus, Inc., 1986, p. 4.

61 Blazek, Jody, "Issues Facing Organizations Preparing the 990 Forms, Taxation of Exempts," May/June 2004, p. 259.

62 Blazek, Jody, "Tax Planning and Compliance for Tax-Exempt Organizations: Forms, Checklists, Procedures," 1999, pp. 234–235.

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