L. DEVELOPMENTS IN THE PRIVATE FOUNDATION AREA

1. Introduction

The purpose of this article is to summarize the recent court cases, notices, revenue rulings, and G.C.M's that deal with issues under the excise tax provisions of Chapter 42 of the Code. Generally, the article summarizes developments since 1985.

2. IRC 4940

A. Introduction

IRC 4940 imposes an excise tax of two percent on the net investment income of private foundations exempt under 501(a). The net investment income consists of the gross investment income and the capital gain net income which exceed the permitted deductions. Gross investment income includes interest, dividends, rents, securities loans payments and royalties. Capital gain net income includes gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents and royalties, and property used to produce unrelated business income.

IRC 4940 imposes an excise tax on non-exempt private foundations to the extent that the tax on the amount which would have been imposed on net investment income and unrelated business income of these private foundations if they were exempt exceeds the tax imposed under subtitle A. (Under this formula a non-exempt charitable trust pays no more combined income and excise tax than it would if it were an exempt organization.)

The section contains two exceptions to the 2 percent excise tax. A private foundation which qualifies as an exempt operating foundation pays no tax. In addition, a private foundation which meets certain distribution requirements, pays a one percent tax instead of a two percent tax.

Recent developments concerning IRC 4940 have centered around three issues: 1) what property sales produce taxable capital gain income, 2) when a taxable sale or other disposition occurs, and 3) what deductions may be made from net investment income.

B. Property Sales Producing Taxable Capital Gains

In Zemurray Foundation v. United States, 755 F.2d 404 (5th Cir. 1985), the court of appeals considered whether the sale of certain property generated taxable income under IRC 4940. On February 21, 1974, Zemurray Foundation, an exempt private foundation, sold its undivided one-half interest in timberland to an unrelated third party. At the time of sale, the foundation had not received any income from the property. The Commissioner determined that the gain from the sale was subject to the IRC 4940 excise tax. The suit for a refund was brought in district court, appealed to the court of appeals (Zemurray I), remanded to the district court, and appealed again to the court of appeals (Zemurray II).

IRC 4940 imposes an excise tax on the sale of "property used for the production of interest, dividends, rents and royalties." Reg. 53.4940-1(f)(1) requires taxation of the sale of "property of a type which generally produces interest, dividends, rents, royalties or capital gains through appreciation." The courts considered two issues involving application of the statute and the regulation to the sale of the timberland.

The first issue was whether the timberland fell into one of the first four categories in the statute and regulations which cover property producing interest, dividends, rents and royalties, and whether the related regulation section was valid. In the first trial, the district court held that the regulation was invalid because it only required that property be a type which generally produces interest, dividends rents and royalties, instead of requiring that the property actually be used for these purposes. In Zemurray I, the court of appeals concluded that the regulation's requirement regarding use was valid, and that the regulation reached property "susceptible of use" in a certain manner even if the property was not actually used in this manner. On remand, the district court concluded that the timberland was theoretically susceptible of use in producing interest, dividends, rents and royalties but was not actually susceptible of use because these uses were not economically prudent or reasonable for the land. In Zemurray II, the court of appeals accepted the district court's interpretation of the "susceptible of use" standard, and accepted the district court's application of the standard to the facts.

The second issue was whether the regulation improperly added a fifth category of taxable property which produces "capital gain through appreciation" to the four categories in the statute. In Zemurray II, the court of appeals agreed with the foundation that the regulation was invalid to the extent that it established the fifth category as an independent basis for taxation under IRC 4940. The court, however, approved a narrow interpretation of the fifth category which applied to property of a type that generally produced interest, dividends, rents or royalties but which is held in a particular situation for capital gains through appreciation. The court gave three reasons for rejecting the government's argument that Congress intended to tax all gains resulting from the disposition of investment-type assets used by a charitable foundation for non-charitable purposes. First, the statute provides that only certain types of capital gains are taxed. Second, Congress had explicitly distinguished between charitable and noncharitable assets in other sections when the distinction was desired. Third, the legislative history of IRC 4940 indicated that Congress rejected the idea of distinguishing assets based on whether they were charitable or noncharitable and adopted the scheme discussed above.

Consequently, the court held that capital gains from the foundation's sale of the timberlands were not includible in the foundation's net investment income for purposes of the excise tax under IRC 4940.

In Greenacre Foundation v. United States, 762 F.2d 965 (Fed. Cir. 1985), Greenacre Foundation, a tax-exempt private operating foundation, received shares of stock as a donation over several years. The securities were publicly traded, and all except one security paid dividends at one time during the years surrounding the gifts. Soon after receipt, the foundation sold the shares realizing capital gain but did not receive any stock dividends while owning the stock. The Service imposed a tax under IRC 4940 on the capital gain realized, and the foundation sued for a refund challenging the validity of Reg. 53.4940-1(f)(1).

The court recognized that the stock sold would be treated as held for investment purposes under Reg. 53.4940-1(f)(1), although it was sold soon after receipt, because it was of a type which generally produced dividends. The court rejected the foundation's argument that the regulation was inconsistent with the related statute, and therefore invalid, because the regulation did not require that property actually be used to produce specified forms of income. The regulation was not unreasonable and plainly inconsistent with the statute because the statute could be read as requiring property actually used to produce specific income or requiring property of the type that normally produces specific income. In support of the regulation's interpretation, the court noted the observation in Friedman Foundation, Inc. v. Commissioner, 71 T.C. 40 (1978). In Friedman, the court had observed that it was unlikely that Congress would tax a particular stock simply because of the fortuity of the receipt of a dividend while a foundation held the stock.

The court also rejected the taxpayer argument that the regulation was internally consistent because in other places it interprets the word "used" to mean actually used. In addition, the court dismissed the foundation's argument that the regulation was inconsistent with the legislative history of IRC 4940 because it reinstated the rejected idea of taxing noncharitable assets. The court held that the portion of the regulations concerning property generally producing interest, dividends, rents and royalties was valid. The court, however, did not address the portion of the regulations which refers to property generating capital gains through appreciation.

G.C.M. 39538 (July, 23, 1986) considered whether all capital gains or losses realized by a private foundation from the sale of noncharitable assets should be considered in determining capital gain net income under IRC 4940(c)(4) in light of Zemurray and Greenacre. G.C.M. 38068 (August 29, 1979) had previously held that capital gain realized from the sale of a diamond ring by a private foundation would be included in the foundation's capital gain net income under IRC 4940. G.C.M. 38068 concluded that net capital gain included all gain on the sale of appreciated capital assets, except for gains on capital assets used for exempt purposes or gains taxable under IRC 511. G.C.M. 39538 rejected the idea of applying the IRC 4940 tax based on whether or not assets were charitable for the reasons given in Zemurray and also revoked G.C.M. 38068. Consequently, the G.C.M. agreed with the portion of the Zemurray opinion concluding that whether property produces capital gains through appreciation is not an independent basis for taxation under IRC 4940.

The broad principle adopted in the G.C.M. combined the determinations under both Zemurray and Greenacre, although the holdings in the opinions partially conflicted. Zemurray concentrated on whether the timberland was susceptible for use generating rents or royalties. This test required that these uses of the land be economically prudent or reasonable. Greenacre focused on whether certain types of property such as stocks, bonds, rental real estate, mineral interests, mortgages and securities were types of property generally producing interest, dividends, rents or royalties. Capital gains or losses from sale of these properties would be included without regard to the foundation's circumstances or the probability of the foundation receiving interest, dividends, etc. The G.C.M. concluded that the Service should apply the Greenacre approach of automatic inclusion for properties listed in Reg. 53.4940-1(f)(1) (stocks, bonds, rental real estate, mineral interests, mortgages and securities) but apply the Zemurray susceptible to use factual inquiry to other property like unimproved land.

The A.O.D. regarding Zemurray expressed the same position as G.C.M. 89538 concerning Zemurray and Greenacre. A.O.D. 1442, Zemurray Foundation v. United States, (June 18, 1987).

C. Occurrence of Sale or Disposition

G.C.M. 39660 (September 9, 1987), considered whether a sale or disposition of property occurred that was subject to the excise tax on capital gain under IRC 4940. X, a private operating foundation described in IRC 4942(j)(3), acquired preserved and maintained historic properties. Y, recognized as exempt under IRC 501(c)(3), provided X a conditional grant of securities and cash to enable X to develop and operate a specific property. The condition attached to the grant was that X had to return the securities and cash if X failed to acquire the property. X, consistent with the terms of the grant, commingled the transferred securities and cash with its investment portfolio.

X failed to acquire the property and returned the grant assets, minus expenses incurred in connection with the attempt to acquire the property, to Y. The assets earned income and appreciated in value during the period that they were held by X. The expenses were paid out of these earnings. The G.C.M. concluded that the return of the conditional grant was not a sale or other disposition of property for purposes of IRC 4940.

D. Deductions from Net Investment Income

In Indiana University Retirement Community, Inc. v. Commissioner, 92 T.C. 56 (1989), the tax court considered an investment income deduction. The City of Bloomington, Indiana issued municipal bonds to provide a private foundation with funds to build retirement community facilities. During construction, the private foundation invested the bond proceeds generating dividends, interest and capital gains. In 1982, the private foundation invested only bond issue proceeds. In 1983, 95 percent of the funds invested were bond issue proceeds and the remaining five percent came from retirement community entrance fees and membership fees. In both years, the private foundation deducted the interest expense incurred on the bonds from its gross investment income, and the Service disallowed the deduction.

When computing net investment income, IRC 4940(c)(3)(A) allows the deduction of ordinary and necessary expenses paid or incurred for the production or collection of gross investment income. The Service argued that the foundation incurred the liability on the bond debt which generated the interest expense in order to provide capital to carry out its tax exempt purposes (constructing a retirement community), instead of to produce investment income. The court, however, held that the private foundation's interest expense was an ordinary and necessary expense paid or incurred for the production of gross investment income because there was a direct nexus and an integral relationship between the bond interest expense and earning gross investment income. The private foundation would not have had funds to invest without the issuance of the bonds and the bond debt would have been in default without the interest payments.

3. <u>IRC 4941</u>

A. Introduction

IRC 4941 is a two-tiered excise tax imposed on each direct or indirect act of self-dealing between a disqualified person and a private foundation. The rules also apply to transactions between certain nonexempt trusts with unexpired interests devoted to charitable purposes and disqualified persons with respect to these trusts. IRC 4947. The tax is paid by disqualified persons and foundation managers who participate in the act of self-dealing. The first tier tax is automatically imposed on each act of self-dealing. The second tier tax is imposed subsequent to the first tier tax if the act of self-dealing is not corrected.

The Code provides a list of transactions which constitute self-dealing in IRC 4941(d)(1) and a list of exceptions to self-dealing in IRC 4941(d)(2). The regulations contain transition rules regarding property held and contracts entered before 1969 when the self-dealing rules became applicable. Reg. 53.4941(d)-4.

In enacting IRC 4941, Congress intended to replace the existing arms-length standard applied to these transactions at that time with a general prohibition against such transactions. S. Rep. No. 91-552, 91st Cong., 1st Sess. 28-29 (1969), 1969-3 CB 442-443. (from G.C.M. 39445) Consequently, the regulations state that it does not matter whether the transaction in question benefits or harms the private foundation. Reg. 53.4941(d)-1(a).

IRC 4941 has been discussed in the following previous CPE issues: 1981 (recent developments), 1982 (application of the statute of limitations), 1985 (general explanation), and 1989 (private foundation scholarship and fellowship grants). This article will discuss the developments in the IRC 4941 area since the general explanation of the provision provided in the 1985 CPE article.

B. IRC 4941(d)(1)(A)

Under IRC 4941(d)(1)(A), the sale or exchange or leasing of property between a private foundation and a disqualified person is a self-dealing act. Recent cases involving this category include direct self-dealing, indirect self-dealing and the self-dealing exception under IRC 4941(d)(2)(F).

G.C.M. 39644 (June 26, 1987) explored whether modifications of pledges to a private foundation constituted an extension of credit under IRC 4941(d)(1)(B) and a sale or exchange under IRC 4941(d)(1)(A). A company, which was a disqualified person with respect to the private foundation, has substituted new larger pledges with later due dates for the original pledges that had not yet become due. The original pledges provided that the foundation could disclose the pledge when borrowing money from financial institutions to carry on its charitable activities, and the foundation used the pledges to help borrow money. The G.C.M. concluded that the substituted pledges were not an extension of credit if the increases in the pledge amount met the fair market interest rates for the extended period. There was no credit extended because the modification discharged the original pledges before maturity, and the disqualified person would not receive any benefit.

The pledges obligated the company to transfer to the foundation the pledged amount in cash or readily marketable intangible assets but the company has instead transferred real property to the foundation as payment of the pledge in several years. The G.C.M. determined that payment in the form of real property was not a sale or exchange of property under IRC 4941(d)(1)(A). The foundation had given nothing in exchange for the debt obligations and so the substitution of property did not present the potential for abuse which was present in situations such as Rev. Rul. 77-379, 1977-2 C.B. 387, in which stock was provided as repayment of a cash loan.

G.C.M. 39445 (November 12, 1985) considered the issue of indirect self-dealing under IRC 4941(a)(1)(A). This G.C.M. involved A, who was the executor of the estate of B and the trustee of twelve charitable remainder annuity trusts (CRATs) funded by the residue of B's estate. A was B's stepson and a beneficiary of one of the CRATs. Ten CRATs provided life annuity interests to B's family members, and two CRATs provided life annuity interests to unrelated persons. The estate exercised the IRC 6166 election for estates with specified holdings in closely held businesses which allowed the estate to remain open for several years. In addition, the estate proposed to lease from A's spouse an office in the personal residence owned by A's spouse. The estate planned to furnish the facilities to the CRATs at no additional charge.

The G.C.M. concluded that whether the estate was a disqualified person was immaterial with regard to the self-dealing question. The issue for indirect self-dealing was whether the lease was a misuse of foundation assets. The G.C.M. reasoned that indirect self-dealing reaches transactions between disqualified persons and intermediary organizations which enable the disqualified person to use the private foundation's assets, and thereby circumvent the self-dealing prohibition. In this case, the intermediary organization, the estate, permitted the disqualified person, A, to use the assets beneficially owned by the CRATs to pay for A's office in his spouse's personal residence. The proposed lease constituted self-dealing because it was a misuse of the CRAT's assets which was arranged by A in his roles as executor and trustee for his private benefit. Moreover, the transaction with the estate was indirectly a transaction with the CRATs for the following reasons: 1) the CRATS would have the estate assets if the estate was not held open due to the 6166 election, 2) the CRATs held all the current beneficial interest in the estate, 3) the estate acted for the CRATs by making distributions to private annuity beneficiaries, 4) the CRATs will ultimately receive the estate assets, and 5) A's responsibilities as estate executor and CRAT trustee were intertwined.

The Court of Appeals for the Federal Circuit applied a self-dealing exception to acts which would have been self-dealing under IRC 4941(d)(1)(A) in <u>Deluxe Corp. v. United States</u>, No. 88-1628 (Fed. Cir. Sept. 12, 1989). The exception under IRC 4941(d)(2)(E) covers stock redemptions in which all the securities of the same class as that held by the foundation are subject to the same terms and these terms provide the foundation fair market value for its stock. Reg. 53.4941(d)-3(d)(1) provides that all securities are not subject to the same terms unless the corporation makes a bona fide offer on a uniform basis to the foundation and all others who hold the securities.

Deluxe Corporation (the "Corporation") conducted a program in which it redeemed its common stock in over-the-counter market transactions and in negotiated purchases off the market. The program permitted no purchases by officers and directors of the Corporation. The claims court adopted the Service position that the prohibition against purchases from officers and directors meant that all shares in the redemption were not "subject to the same terms" as required in IRC 4941(d)(2)(F) and therefore did not qualify for the self-dealing exception. The court of appeals concluded that the redemption met the exception for stock redemptions under IRC 4941(d)(2)(F) because Reg. 53.4941(d)-3(d)(1) did not require shareholders who are officers and directors to be included in the redemption program and the redemptions were at no less than fair market value.

The court reasoned that the ban on officers and shareholders was based on their position as insiders instead of on their position as shareholders. Consequently, the ban furthered the statutory purpose of preventing those controlling a disqualified person from using their position for a prohibited purpose. Moreover, requiring the participation of officers and directors who are shareholders would create a potential conflict with securities laws restrictions regarding these persons.

C. IRC 4941(d)(1)(D)

IRC 4941(d)(1)(D) provides that a payment of compensation (or payment of expenses) by a private foundation to a disqualified person is an act of self-dealing. G.C.M. 39660 (September 9, 1987) considered the exception to the prohibition against private foundations compensating disqualified persons. The private foundation in this G.C.M. purchased limited partnership interests in a limited partnership. C was a disqualified person with respect to the private foundation. The general partners made C the managing partner and paid C compensation for acting as the investment advisor for the partnership. The limited partnership was not a disqualified person under IRC 4946(a)(1)(F) because C owned only a 1 percent profits interest in the partnership. Consequently, investment in the limited partnership and payment of expenses was not self-dealing. In addition, the payment of C's investment advisory fees by the partnership did not result in indirect self-dealing because the payments fell under the self-dealing exception in IRC 4941(d)(2)(E) for reasonable compensation provided by a private foundation to a disqualified person for personal services which were reasonable and necessary to carrying out the private foundation's exempt purposes.

D. 4941(d)(1)(E)

Most of the activity in revenue rulings, court cases, and G.C.M.'s in the last five years has centered around IRC 4941(d)(1)(E). IRC 4941(d)(1)(E) prohibits any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or the assets of a private foundation.

G.C.M. 39770 (Dec. 15, 1988) considered a situation involving direct self-dealing under IRC 4941(d)(1)(E). In this case, H bequeathed his interest in community property art, owned with W his wife, to a private foundation which operated a museum. Consequently, W and the beneficiary foundation became tenants in common with respect to the community property art at H's death. W, who was a disqualified person with respect to the foundation, wanted to display a small portion of the community property art in her home on a revolving basis. As tenants in common under state law, W and the foundation both were entitled to possession of this art. Although W has the right to use the community property art under state law as a tenant in common with the foundation, the G.C.M. concluded that the use by W of the art would violate the IRC 4941(d)(1)(E) prohibition against self-dealing. The G.C.M. noted that the self-dealing exception under Reg. 53.4941(d)-4(e)(1) for the use of property held jointly by a private foundation and a disqualified person before October 9, 1969 applies only to ownership existing at that time.

G.C.M. 39741 (June 20, 1988) also involved direct self-dealing under IRC 4941(d)(1)(E). The founders of a private foundation donated part of their sculpture collection to the private foundation and loaned the remainder of the collection to the private foundation. The foundation exhibited the sculpture on the estate of the founders mainly in the general area of the founder's house and pool. The founders were disqualified persons with respect to the foundation and, consequently, their use of the foundation sculpture was self-dealing under IRC 4941(d)(1)(E). The G.C.M. noted that the founder also did not meet the exception to self-dealing for incidental benefits under Reg. 53.4941(d)-2(f)(2) because the founders enjoyed a direct benefit.

In Estate of Bernard J. Reis v. Commissioner, 87 T.C. 1016 (1986), the Tax Court considered the issue of indirect self-dealing under IRC 4941(d)(1)(E). Bernard Reis was an executor of the Estate of Mark Rothko, a director of the Mark Rothko Foundation, and an officer and employee of Marlborough Gallery, Inc. The executors of the estate (including Reis) entered a contract, on behalf of the estate, with Marlborough Gallery authorizing the gallery to sell the Rothko paintings for 12 years with a commission totaling 50 percent of the sale price of each painting. In response to a suit brought by Mark Rothko's family, New York State courts removed Reis and other estate executors, voided the gallery contract and awarded the estate monetary damages. Afterwards, the Service audited the foundation and determined that Reis was liable for self-dealing excise taxes under IRC 4941.

The Tax Court denied a motion for summary judgment by the estate which was based on three alternative legal arguments. The court rejected the estate's argument that IRC 4941(d)(1)(E) was so vague that it should be held unconstitutional. The estate also argued that the paintings covered by the contract with the gallery were property of the estate and consequently the contracts could not have constituted acts of self-dealing by Reis with respect to foundation assets. The Tax Court responded that the self-dealing rules applied because the expectancy interest of the foundation under state law in the estate property was treated as a foundation asset. In addition, the court disagreed with the estate's argument that the benefits referred to in IRC 4941(d)(1)(E) only include pecuniary benefits. Finally, the court denied the Service's motion for summary judgment because it would not take judicial notice of the specific findings of fact from the New York State litigation.

G.C.M. 39632 (May 12, 1987) also considered whether indirect self-dealing occurred under IRC 4941(d)(1)(E). The G.C.M. concerned the trustee of a private foundation who was an attorney. The attorney incorporated a for-profit corporation for one of his clients who was the sole stockholder of the corporation. In addition, the attorney and his wife were officers and directors in the corporation. The attorney arranged a loan to the corporation from the private foundation. The G.C.M. concluded that arranging the loan was indirect self-dealing under IRC 4941(d)(1)(E) because the attorney benefited himself by using the private foundation assets on behalf of another client. The benefits were not incidental within the meaning of reg. 53.4941(d)-2(f)(2) because the attorney substantially enhanced his reputation with a longstanding, influential client by arranging the loan from the private foundation. Whether the terms of the loan were favorable for the foundation was not determinative.

Rev. Rul. 85-162, 1985-2 C.B. 275, considered a situation in which the benefit provided to the private foundation was incidental. In this revenue ruling, P, a private foundation, entered a master loan agreement which extended an interest-free line of credit to C, a public charity, who lent the borrowed funds at substantially below market interest rates to community development organizations. The community development organizations, which were also public charities, used loan proceeds to purchase certificates of deposit to facilitate acquisition of financing for construction projects in disadvantaged areas. The master loan agreement prohibited the community development organizations from purchasing certificates of deposit from any disqualified persons with respect to P, prevented the disqualified persons from providing construction or permanent financing, and prohibited P or any disqualified person from participation in the selection of contractors, subcontractors or suppliers. Some contractors and subcontractors, however, did have ordinary banking or business relationships with the disqualified person banks.

The revenue ruling determined that there were no acts of self-dealing resulting from the ordinary banking and business relationships which contractors and subcontractors had with banks which were disqualified persons with respect to P. Any benefit to the disqualified persons was incidental within the meaning of Reg. 53.4941(d)-2(f)(2).

G.C.M. 39547 (August 22, 1986) considered the self-dealing exception for general banking and trust services provided by banks and trust companies which are disqualified persons. Reg. 53.4941(d)-2(c)(4). The G.C.M. involved a private foundation that was funded with gifts from company A and a subsidiary of A. The foundation's Board of Trustees consisted of four individuals who were officers of A and four individuals who were not associated with A. The foundation proposed investing in a common trust fund, created for exempt organizations, which invested in real estate. A subsidiary of A established the trust fund and appointed A as the investment manager of the fund. The trust company would receive a management fee and would compensate A and a management company for investment and marketing services.

The trust company was a disqualified person with respect to the private foundation under IRC 4946(a)(1)(E) because it was a subsidiary of A which was a substantial contributor. The payment of compensation by a private foundation to a disqualified person constitutes self-dealing under IRC 4941(d)(1)(D). The G.C.M., however, concluded that the payment of compensation by the foundation to the trust company for investment services was excluded from self-dealing by the exception in IRC 4941(d)(2)(E). This exception covers compensation paid for personal services which are reasonable and necessary to carrying out the private foundation's exempt purpose if the compensation is not excessive. In support of this conclusion, the G.C.M. noted the self-dealing exclusions in example 2 in Reg. 53.4941(d)-3(c) for a disqualified person who manages a private foundation's investment portfolio, and in Reg. 53.4941(d)-2(c)(4) for general banking services provided for a private foundation by a bank or trust company which is a disqualified person.

In addition to the compensation issue, the G.C.M. discussed whether the provision by a disqualified person of an investment vehicle for private foundations constituted self-dealing prohibition pursuant to IRC 4941(d)(1)(E). The G.C.M. concluded that the investment of assets in the common trust fund was similar to investment in a savings account of a disqualified person bank which is permissible as a general banking service under Reg. 53.4941(d)-2(c)(4). The G.C.M. reasoned that the trust company was merely managing a portion of the foundation's investment portfolio.

One question that the G.C.M does not address is whether Reg. 53.4941-2(c)(4) imposes any requirements with respect to liquidity when foundation assets are invested in a common fund maintained by a disqualified person. The regulation is clear on the terms under which foundation assets may be invested in savings accounts. The unanswered question is whether similar terms are imposed when assets are invested in a common fund.

E. Transitional Rules

Rev. Rul. 86-53, 1986-1 C.B. 326, applied the transition rules in Reg. 53.4941(d)-4(b)(1) to a situation where stock holdings did not become excess business holdings until after IRC 4943 took effect. Normally these regulations are used to permit private foundations to dispose of the stock which became excess business holdings when IRC 4943 took effect.

Rev. Rul. 86-53 involved a private foundation and disqualified persons which together had owned 100% of the outstanding stock of M, a for-profit corporation, since May 26, 1969. The number of M shares owned by the private foundation had not changed during this time. Prior to 1985 M was excepted from the definition of “business enterprise” because 95% or more of its income consisted of rent from real property. In 1985, the character of M’s income changed and less than 95% of its income consisted of rents from real property.

The private foundation needed to sell M stock in 1985 when M became an excess business holding due to a change in its sources of income. The sale of M stock to a disqualified person was excepted under Reg. 53-4941(d)-4(b)(1) from the IRC 4941 self-dealing prohibition because the private foundation sold the M stock to avoid tax liability under IRC 4943, received an amount equal to the stock's fair market value and participated in a transaction which was not a prohibited transaction pursuant to IRC 503(b).

Since the 1990 CPE text was published, the Tax Court has handed down a decision and the Service has issued a G.C.M. that supplement the text.

In G.C.M. 39808, January 16, 1990, Counsel concluded that the Service can adjust the excess distribution carryover for years not barred by the statute of limitations by recalculating the distributable amount of qualifying distributions for years that are closed.

In Kermit Fischer Foundation v. Commissioner, TCM 1990-300, June 18, 1990, the Court held that the petitioners (including the foundation manager) had not shown that the payments made to the foundation manager were not unreasonable compensation. Based on this finding the Court found that the petitioners owed IRC 4941, 4945 and 4940 tax.

4. IRC 4942

A. Introduction

IRC 4942 imposes a two-tiered excise tax on the undistributed income of a private foundation. The first tier tax of 15% is imposed on undistributed income of a foundation which has not been distributed before the first day of the second taxable year following the taxable year at issue. The second tier tax of 100% is imposed on the undistributed income remaining on the earlier of the date the deficiency notice for the first tier tax is mailed or the date the first tier tax is assessed. There is one group of foundations - private operating foundations - that are excepted from the IRC 4942 tax. In order to qualify as an operating foundation, a private foundation must make qualifying distributions directly for the active conduct of charitable activities equal to the lesser of adjusted net income or minimum investment return, and satisfy either the assets test, endowment test or support test.

The undistributed income is the amount by which the distributable amount for the taxable year exceeds the qualifying distributions. The distributable amount equals the sum of minimum investment return and the amounts described in IRC 4942(f)(2)(C) (amounts described in IRC 4942(f)(2)(C) are repayments of amounts which were previously classified as qualifying distributions, amounts received from the disposition of property to the extent that the property acquisition had been considered a qualifying distribution, and any portion of a set-aside determined not to be necessary for the purposes for which it was set aside) reduced by the taxes imposed by subtitle A (e.g. UBIT) and IRC 4940. Minimum investment return consists of five percent of the excess of the aggregate fair market value of all foundation assets not used for the foundation's exempt purpose over the acquisition indebtedness with respect to these assets.

If the qualifying distributions exceed the distributable amount for a taxable year, the excess may be carried forward five taxable years to reduce the amount of qualifying distributions required in those years.

Qualifying distributions consist of amounts (including certain administrative expenses) paid to accomplish IRC 170(c)(2)(B) purposes, amounts paid to acquire assets used directly in carrying out IRC 170(c)(2)(B) purposes, and certain set-asides. IRC 170(c)(2)(B) purposes include religious, charitable, scientific and literary purposes, fostering national or international amateur sports competition, and prevention of cruelty to children or animals. IRC 4942 treats set-asides as qualifying distributions if an amount is set aside for a project that is better accomplished by a set-aside than by immediate payment, or if certain minimum amounts are distributed over a specific time period.

IRC 4942 compels private foundations to distribute income in furtherance of their charitable purposes. Previously, private foundations had often failed to make these charitable distributions because they were investing in assets that produced no current income. H.R. Rep. No. 413, 91st Cong., 1st Sess. 25 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 35 (1969).

IRC 4942 has been discussed in the following previous CPE issues: 1982 (application of the statute of limitations), 1984 (set-asides), 1985 (IRC 4942 changes including the limitation on administrative expenses treated as qualifying distributions), and 1988 (qualifying distributions). This section explores the application of IRC 4942 since 1985.

B. Distributable Amount

The following court case involves the computation of the distributable amount. For taxable years ending after December 31, 1981, the distributable amount is computed by reference to the minimum investment return. For taxable years ending before January 1, 1982, the greater of minimum investment return or adjusted net income is used to compute the distributable amount.

In Stanley O. Miller Charitable Fund v. Commissioner, 89 T.C. 1112 (1987), the Tax Court considered whether short-term and long-term capital losses could be used to reduce the amount of undistributed income for Stanley O. Miller Charitable Fund for its taxable years ending in 1981 through 1984. The fund was a trust which qualified as an exempt private foundation. As mentioned above, consideration of tax years ending before the end of 1981 requires consideration of both minimum investment return and adjusted net income.

IRC 4942(f)(2)(B) provides that capital gains and losses from the sale or other disposition of property shall be taken into account only in an amount equal to any net short-term capital gain for the taxable year in computing adjusted net income. The Tax Court concluded that IRC 4942(f)(2)(B) allows short-term capital losses to be considered only in an amount equal to net short-term capital gains for the taxable year, and provides no adjustment for long-term capital gains or losses. Consequently, the trust could not deduct either its long-term or short-term capital loss from its adjusted net income. The court also concluded that losses could not be used to reduce the minimum investment return. In summary, the court held that capital losses could not be used to reduce the distributable amount.

The court also rejected four arguments that IRC 4942 was unconstitutional. First, the court concluded that imposing a penalty, based on a prescribed rate of return on non-charitable assets, did not exceed Congress's power under section 8, clause 1 of article I which authorizes Congress to collect excise taxes to pay the public debt, and provide for the common defense and general welfare. The Supreme Court has repeatedly stated that a tax which regulates or discourages the activities taxed is a legitimate exercise of the taxing power.

Second, the court determined that IRC 4942 is not a tax on property or the income from property which violates the prohibition in Section 9 of Article 1 against a direct tax not apportioned among the several States in proportion to population. The IRC 4942 tax is not a direct tax because it is imposed upon a particular use of property and not on the general ownership of property.

Third, the court rejected the argument that IRC 4942 requires distribution of trust corpus by decreeing that private foundation trusts have income when they actually have losses in violation of the fifth amendment prohibition against confiscation of property without due process of law. Instead of taking property without due process of law, the section gives private foundations a choice between paying the IRC 4942 tax and making the required distribution. Congress could have made the continuation of exemption under IRC 501(c)(3) dependent on the prescribed distributions.

Fourth, the court concluded that the IRC 4942 tax does not violate the 16th Amendment power to lay and collect taxes on incomes. The 4942 tax is not an income tax but an excise tax governed by whether a foundation fails to distribute the required amount. In light of the above conclusions, the court held that IRC 4942 does not violate the United States Constitution.

C. Qualifying Distributions

Several recent G.C.M.'s consider the characteristics of a qualifying distribution, the application of the set-aside rules, and the effect of an asset transfer and private foundation termination on qualifying distributions.

The issue in G.C.M. 39561 (September 30, 1986) is whether a private foundation's expenditure was a qualifying distribution as defined in IRC 4942. An exempt private foundation received all of the stock of a taxable corporation which it then liquidated. The foundation continued to operate the business, previously held by the taxable corporation, as an unrelated business until the business was sold. After the sale, the EPA determined that hazardous substances were present at the site of the business and that it was necessary to take action to mitigate the threat of further release of hazardous substances into the environment. Without admitting liability, the Foundation and another company, which had operated at the site, entered into an Administrative Order by Consent with the EPA and with a similar state department to determine the best method of cleaning up the area. In addition, the foundation planned to make expenditures and solicit contributions from other parties who owned or operated the facility on the site to clean up any pollution or hazardous substances at the site.

The G.C.M. determined that the expenditures made to clean up any pollution or hazardous substances at the site were not qualifying distributions as described in IRC 4942. Although protecting or restoring the environment can be charitable, the transfer of money or property would have to be a gift without receipt or expectation of financial or economic benefit to be an IRC 170(c)(2)(B) contribution and, therefore, a qualifying distribution under IRC 4942(g)(1)(A). Instead, the motivation for the study and cleanup was the foundation's potential liability and the expectation that the foundation would extinguish this liability upon completion of the cleanup. In addition, the cleanup expense would not satisfy IRC 4942(g)(1)(B) because the assets creating the problem were not used directly in carrying out IRC 170(c)(2)(B) purposes. The assets were used to operate an unrelated business.

G.C.M. 39632 (May 12, 1987) also considered the issue of what constitutes a qualifying distribution. The G.C.M. concluded that the forgiveness by an exempt private foundation of the rent due from a church for the use of certain property was not a qualifying distribution under IRC 4942(g)(1)(A). The G.C.M. reasoned that there must be an actual payout during the taxable year in order to create a qualifying distribution. This rationale was consistent with G.C.M. 35831 which concluded that the depreciation on assets used for charitable purposes was not a qualifying distribution.

G.C.M. 89442 (November 8, 1985) considered a proposed set-aside by a private operating foundation. A new foundation, organized exclusively for charitable purposes, planned to set aside all of its income to purchase or construct a health care facility within 60 months from the date of the foundation's formation. The G.C.M. determined that the new foundation's plans to set aside funds was a direct charitable activity which constituted a qualifying distribution adequate to sustain an advance ruling that the foundation was an operating foundation as defined in IRC 4942(j)(3). The G.C.M. reasoned that money set-aside to fund future projects constituted the active conduct of activities furthering the foundation's exempt purpose, although no actual charitable services had yet been provided. While Congress did not specify what constitutes direct charitable activity under IRC 4942(j)(3), the statute indicates that Congress intended to permit private foundations with projects that require an accumulation of funds an opportunity to set their plans in motion.

D. Operating Foundation Status

The Tax Court considered the issue of whether an organization qualified as an operating foundation under IRC 4942(j)(3). "Miss Elizabeth" D. Leckie Scholarship Fund v. Commissioner, 87 T.C. 251 (1986). The "Miss Elizabeth" D. Leckie Scholarship Fund, exempt under IRC 501(c)(3), provided scholarships to assist the children of Butler County residents obtain a college education. Butler was one of the poorest counties in Alabama. The court held that the foundation qualified as a private operating foundation because it made qualifying distributions directly for the active conduct of the foundation's exempt activities and met the endowment test in IRC 4942(J)(3).

Instead of simply selecting, screening and investigating scholarship applicants, the court concluded that the foundation actively conducted its exempt activities in the following ways. The foundation board maintained contact with the scholarship recipients, assisted them in finding summer jobs in Butler County, introduced them to local officials, business and professional leaders of the county, conducted county tours and compiled data promoting the county. The "significant involvement" test in Reg. 53.4942(b)-1(2)(ii)(A) also indicated active conduct. The foundation also met the "significant involvement" test because it helped to relieve poverty by aiding needy students in Butler County.

In addition, the foundation met the endowment test in IRC because it made qualifying distributions directly for the active conduct of its charitable activities which were greater than two-thirds of its minimum investment return. The court rejected the Service position that the foundation was not the type of organization the Congress intended to meet the endowment test. The Service argued that the endowment test only applies to organizations whose personal services are so great in relation to their charitable assets that they are unable to pay for the personal services out of their small endowment. In 1987-1 C.B. 1, the Service acquiesced in the result relating to whether the foundation qualified as an operating foundation.

5. <u>IRC 4943</u>

A. Introduction

IRC 4943 imposes a two-tiered tax on private foundation for excess holdings in a business enterprise. The initial tax is equal to 5% of the value of these holdings. The additional tax is equal to 200% of the value of any excess business holdings remaining on the earlier of the date the Service mails the deficiency notice for the initial taxes or the date the initial tax is imposed.

Excess business holdings are the holdings of a private foundation in a business enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for its remaining holdings in the enterprise to qualify as permitted holdings. These business enterprises do not include functionally related businesses or businesses with at least 95% of its income from passive sources.

Private foundation holdings in a business enterprise are permitted holdings if they meet one of three tests. First, permitted holdings may include 20% of the voting stock in a business enterprise, reduced by the percentage of voting stock owned by all disqualified persons. If all disqualified persons together do not own more than 20% of the voting stock, nonvoting stock held by the private foundation may also be permitted holdings. Second, the permitted holdings of the private foundation and the disqualified persons together may include up to 35% of the voting stock of a business enterprise, if a disqualified person does not have effective control of the business enterprise. Third, a private foundation may own up to 2% of the voting stock and up to 2% of the value of all outstanding shares of stock together with other private foundations described in IRC 4946(a)(1)(H). These private foundations include private foundations that are controlled by or receive substantially all their contributions from the same persons as the private foundation in question.

The rules regarding permitted holdings also apply to interests in partnerships or joint ventures, and beneficial interests in other business forms except for proprietorships. There are no permitted holdings in proprietorships. When applying the rules, the interests in other entities held by a corporation, partnership, estate or trust will be considered as owned proportionately by private foundations and disqualified persons which are shareholders, partners or beneficiaries.

IRC 4943(c)(4) provides transition rules for private foundations that had excess business holdings on May 26, 1969. The permitted holdings for these foundations in combination with disqualified persons are equal to the percentage interest held on May 25, 1969 not in excess of 50%. Generally, if the combined holding percentage decreases, then the new lower amount becomes the new permitted holding amount.

IRC 4943(c)(4) provides three phases for foundations to reduce their holdings to an acceptable percentage, although this percentage may exceed the permitted holdings for new private foundations. The first phase lasts either 20, 15 or 10 years depending on the percentage of the business interest held by the private foundation alone or in combination with disqualified persons. During this time, business interests held by the private foundation will be treated as held by a disqualified person instead. The combined holdings must not exceed 50% of the voting stock and the value of all stock by the end of the first phase.

The second phase, which lasts 15 years, allows the holdings of the private foundation in combination with the disqualified persons to remain 50%. The private foundation, however, must reduce its holdings to 25% of the voting stock and the value of all stock if all disqualified persons together hold in excess of 2% of the voting stock.

The third phase covers all time after the second phase. If the 25% limit does not apply to the private foundation in the second phase, then the combined holdings of the private foundation and disqualified persons must be reduced to 35% by the beginning of the third phase. If all disqualified persons together acquire more than 2% of the voting stock in the third phase, then the combined holdings are limited to 35% with the private foundation owning no more than 25% of the voting stock and the value of all stock.

The transition rules also apply to private foundation interests in business enterprises acquired under the terms of a trust which was irrevocable on May 26, 1969, or under a will executed on or before this date. Except for these wills and trusts, a private foundation may treat excess business enterprise holdings acquired after May 26, 1969 (other than by purchase by a private foundation or a disqualified person) as held by a disqualified person, instead of the private foundation, for a five year period. This rule allows the private foundation five years to dispose of these holdings. This period may be extended an extra five years if the private foundation has received an unusually large gift or bequest with diverse business holdings or holdings with complex corporate structures, and the private foundation is therefore unable to dispose of the holdings except at a price substantially below fair market value.

The purpose of enacting IRC 4943 was to limit the extent to which a business may be controlled by a private foundation. Congress observed that when a foundation's stock holdings provide the foundation control of a business, foundation managers are likely to focus their attention on maintenance and improvement of the business instead of on their charitable duties. In addition, the business controlled by a private foundation may be conducted in a way which unfairly competes with taxable business owners. H.R. Rep. No. 413, 91st Cong., 1st Sess. 27 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 38 (1969).

IRC 4943 has been discussed in the following CPE texts: 1983 (explanation of general rules and transition rules) and 1985 (legislative changes).

B. Transition Rules

G.C.M. 39505 (May 9, 1986) considered the application of the transition rules for property received from wills executed on or before May 26, 1969 and in effect from that date under IRC 4943(c)(5). Reg. 53.4943-5(a)(4) provides that amendment or republication of a will which was executed on or before May 26, 1969, does not prevent the application of the transition rules to the business enterprise interest passed under the will as long as there is no change in the rights of the private foundation designated as the beneficiary under the original will.

In this case, the testator executed numerous wills and codicils between 1963 and 1973 each of which designated either of two exempt private foundations as the residuary beneficiary. The two private foundations were R Foundation and N Foundation. The Articles of Incorporation and By-laws of R and N were almost identical. In addition, the provisions in the May 1969, and the October 1973, wills instructing the foundations' boards of directors how to spend the money received were the same. Between April 20, 1967, and September 2, 1970, N was the residuary beneficiary. On October 29, 1971, N dissolved and contributed its remaining assets to R. Between January 13, 1971, and October 31, 1973, R was the residuary beneficiary.

The G.C.M. concluded that the will executed before May 26, 1969 designating N Foundation as the residuary beneficiary did not cause the transition rules to apply to assets received by R Foundation under the will executed after May 26, 1969. Rev. Rul. 81-119, 1981-1 C.B. 512, concludes that the transition rules applied to the business interests received by a foundation under a will executed after May 26, 1969 because the testator had executed a will before May 26, 1969 designating the same foundation as the sole residuary beneficiary. The only change with regard to the foundation was an increase in its bequest. G.C.M. 37861 (February 22, 1979), upon which the revenue ruling was based, considered the second will as a republication of the first will.

The rationale involved when the same foundation is the beneficiary in two wills did not apply when the beneficiaries under the wills were two separate legal entities, N Foundation and R Foundation. A common founder, a common purpose and some common directors did not mean that the foundations were not separate legal entities. The residuary clause in the later will was not a republication of the earlier wills. Consequently, the interests obtained by the foundation under the terms of the will executed after May 26, 1969 were not treated as obtained under a will executed on or before May 26, 1969.

6. IRC 4944

A. Introduction

IRC 4944 imposes a two-tiered tax on private foundations and foundation managers. The private foundation pays a 5% initial tax on the amount of any investment which jeopardizes the carrying out of any of its exempt purposes. The foundation managers pay an initial tax of 5% on the amount of the jeopardizing investment (with a $5,000 limit) for participating in making the investment, knowing that it jeopardizes the carrying out of any of the foundation's exempt purposes. The foundation managers can avoid the tax if the participation is not willful and is due to reasonable cause.

After the initial tax, IRC 4944 imposes on private foundations an additional tax of 25% on the investment amount if the private foundation does not remove the investment from jeopardy before the mailing of a deficiency notice for the initial tax or the imposition of the initial tax. IRC 4945 imposes on foundation managers an additional tax of 5% on the investment amount (with a $10,000 limit) for the refusal to agree to remove all or part of the investment from jeopardy. The sale or other disposition of an investment removes it from jeopardy. In addition, foundation managers are jointly and severally liable for the taxes imposed on them.

Investments made for the primary purpose of accomplishing IRC 170(c)(2)(B) purposes (program-related investments), with no significant purpose of producing income or appreciation, are not considered as investments which jeopardize the carrying out of exempt purposes.

When enacting IRC 4944, Congress reasoned that if foundation assets are used in a way that jeopardizes their use for exempt purposes, then charities do not receive the benefits which justify the tax benefits provided to donors and exempt organizations. There was a concern that private foundation managers were able to invest foundation assets in high risk investments such as warrants, commodity futures and options, or to purchase on the margin. Consequently, Congress designed IRC 4944 to limit the types of investments made with foundation assets. S. Rep. No. 552, 91st Cong., 1st Sess. 44 (1969).

The 1988 CPE text discussed IRC 4944 generally and its relationship to other chapter 42 provisions. This section will review decisions occurring since 1985 which involve IRC 4944. The issues in these decisions involve whether certain transactions qualify as an investment, a program-related investment, or a jeopardizing investment.

B. Jeopardizing Investments

G.C.M. 39660 (September 9, 1989) considered whether a transaction was an investment subject to IRC 4944. X, a private operating foundation described in IRC 4942(j)(3), acquired, preserved and maintained historic properties. Y, recognized as exempt under IRC 501(c)(3), provided X a conditional grant consisting of cash and securities to enable X to develop and operate a specific property. The grant required that X return the grant if X failed to acquire the property. X failed to acquire the property and returned the grant assets, minus expenses incurred in connection with the property, to Y. X and Y agreed, for purposes of returning the grant to value the securities on January 23, 1984 and completed the transfer on February 2, 1984. A pending takeover bid caused the market value of one class of stock returned by X to increase sharply between the January 23, 1984 valuation and the February 2, 1984 transfer.

There was a concern that X failed to exercise ordinary business care in the method used to return the securities to Y and, thereby, made a jeopardizing investment. The G.C.M. concluded that the increase in value of the stock between the time it was valued and the time it was returned to Y was not equivalent to a disinvestment or dissipation of the foundation's assets. Thus, the transfer of stock by X back to Y was not an investment and should not be considered under the jeopardizing investment analysis of IRC 4944.

G.C.M. 39537 (July 18, 1986) considered whether large stock purchases by an exempt private foundation using borrowed funds were jeopardizing investments under IRC 4944(a)(1). Over a two year period, the foundation borrowed large amounts of money to purchase publicly traded stock in a corporation. Investment rating services concluded that the stock to be average in safety and price performance. All three of the foundation's trustees who supervised the foundation's investments had connections with the corporation. One trustee was an auditor for the corporation and arranged SEC filings. Another trustee was president and general manager of a wholly owned subsidiary of the corporation. The third trustee was a vice president and controller of a subsidiary of the corporation. The foundation's investment in the corporation comprised an average of 75% of the foundation's total investments.

The G.C.M. concluded that the combined impact of three factors made the stock holdings a jeopardizing investment triggering an initial tax under IRC 4944(a)(1). The three factors were: the large bank loans to buy the stock, the lack of sufficient diversification of the foundation's investments, and the nature of the corporation involved which was less than blue chip quality. These factors indicated that the foundation managers did not exercise ordinary business care and prudence as required in Reg. 53.4944-1(a)(2)(i) when investing in the stock.

In contrast, the G.C.M. concluded that a tax on foundation managers under IRC 4944(a)(2) was not appropriate. In the absence of evidence that the managers attempted to personally profit from the large foundation transactions, there was no proof that the foundation managers made the investments willfully or without reasonable cause.

C. Program-related Investments

G.C.M. 39720 (March 30, 1988) examined whether the investment of an exempt private foundation qualified as a program-related investment as defined in IRC 4944(c). The purpose of the foundation was to carry on various activities designed to improve life in an economically depressed area. The foundation and several other nonprofit investors proposed to invest in X, a holding company, that would invest in a non-profit entity as a 50% owner and in a for-profit corporation as a 100% owner. The for-profit corporation planned to make equity investments in new or expanding business ventures that showed a promise of achieving high levels of growth and profitability. Although most of the corporation's investments would be in the target area, up to 15% of the investments would be made outside the target area. The rate of return to the foundation and other investors from X was limited to 5% for the first 5 years. The foundation argued that investments outside the target area would create a network indirectly benefiting the target area by providing the for-profit corporation access to a nationwide network of venture capital sources.

The G.C.M. concluded that the proposed investment program was a program-related investment by applying the three tests in Reg. 53.4944-3(a)(1). First, the primary purpose of the investment was to accomplish an IRC 170(c)(2)(B) purpose. The investment was made to further the foundation's charitable purpose and would not have been made except to achieve this charitable purpose. Second, no significant purpose of the investment was the production of income or the appreciation of property. The for-profit corporation's investment of up to 15% of its assets outside the target area was the issue. The small portion of the corporation's assets (15%) that could be invested outside the target area and the networking purpose associated with these outside investments, however, indicated that the purpose of the investment was not to produce income or appreciation. Third, the investment did not have as a purpose influencing legislation or the outcome of an election because there were restrictions against the company using its funds for these purposes. Classification as a program-related investment meant that the investment in the holding company could not be considered as a jeopardizing investment.

7. <u>IRC 4945</u>

A. Introduction

IRC 4945 imposes a two-tiered tax on private foundations and foundation managers. There is an initial tax of 10% on private foundations for taxable expenditures. There is also an initial tax of 2 1/2% (with a $5,000 limit) on foundation managers for agreeing to make a taxable expenditure, knowing that it is a taxable expenditure, unless the agreement is not willful and is due to reasonable cause. After the initial tax, IRC 4945 imposes an additional tax of 100% on private foundations if they do not correct a taxable expenditure before the mailing of a deficiency notice for the initial tax or the imposition of the initial tax. IRC 4945 imposes an additional tax of 50% (with a $10,000 limit) on foundation managers for the refusal to agree to part of all or the correction. In addition, foundation managers are jointly and severally liable for the taxes imposed on them.

Taxable expenditures include amounts paid or incurred to: 1) carry on propaganda or attempt to influence legislation, unless the legislation directly affects the private foundation, 2) influence a public election or conduct a voter registration drive, except for nonpartisan activities by certain organizations, 3) provide a grant to an individual for travel, study or similar purpose, unless grants meet certain criteria and are approved in advance by the Service, 4) make grants to an organization which does not qualify as a public charity or an exempt operating foundation under IRC 4940(d)(2), unless the private foundation exercises expenditure responsibility with respect to the grants, or 5) carry on purposes which are not described in IRC 170(c)(2)(B).

In enacting IRC 4945, Congress intended to place more effective limitations on the activities described as taxable expenditures. In the past, the only penalty for more than insubstantial lobbying activity and for any political campaign activity had been a loss of exemption. Consequently, the penalty on campaign activity was so severe that it would not be enforced and the substantiality test allowed large organizations to engage in more lobbying activity than small organizations. Moreover, there was a need to limit the definition of educational grants and to make granting foundations take substantial responsibility for the proper use of funds they give away. H.R. Rep. No. 413, 91st Cong., 1st Sess. 31 (1969); S. Rep. No. 552, 91st Cong., 1st Sess. 46 (1969).

IRC 4945 has been discussed in the following CPE texts: 1980 (grants to individuals), 1982 (scholarships and racially restricted scholarship trusts), 1983 (scholarships), 1984 (decentralization of advance approval of IRC 4945(g) grant-making programs), 1985 (changes to expenditure responsibility rules), 1987 (legislative changes), 1989 (TAMRA effect on scholarships and fellowships).

B. Attempts to Influence Legislation

Notice 88-76, 1988-2 C.B. 392, considers whether a certain activity qualifies as an attempt to influence legislation. The notice concluded that attempts by a private foundation to influence the Senate confirmation of an individual nominated by the President to serve as a federal judge does not constitute influencing the outcome of a public election within the meaning of IRC 4945(d)(2). Such activity does, however, constitute carrying on propaganda or otherwise attempting to influence legislation within the meaning of IRC 4945(d)(1). Consequently, this activity is a taxable expenditure under IRC 4945(d). There is a full discussion of the notice in the 1989 CPE on pages 70-74.

C. Individual Grants under IRC 4945(g)(1)

Most of the activity regarding IRC 4945 has occurred in the scholarship area. Educational grants generally must meet the requirements in IRC 4945(g)(1) to avoid classification as taxable expenditures. This section provides an exception for certain educational grants from the general rule in IRC 4945(d)(3) that grants to individuals for travel, study or similar purposes are taxable expenditures. IRC 4945(g)(1) has four requirements: 1) grants must be awarded on an objective and nondiscriminatory basis, 2) advance approval of grant procedure must be obtained, 3) scholarship or fellowship grants must meet the requirements of IRC 117, and 4) grants used for study at an educational organization described in IRC 170(b)(1)(A)(ii). The following sections will demonstrate the application of these rules to educational grants.

1. Objective and Nondiscriminatory Basis of Scholarship

Rev. Rul. 85-175, 1985-2 C.B. 276, examines whether an exempt private foundation's grant procedures are objective and nondiscriminatory. The foundation plans to conduct a scholarship program as an insubstantial part of its activities. The scholarships will be awarded on the basis of financial need and academic achievement. If the financial need and academic achievement of several scholarship candidates are substantially the same, preference may be given to candidates who are family members and relatives of the trust's grantor.

The revenue ruling concludes that the grants are not awarded on an objective and nondiscriminatory basis as required by IRC 4945(g) and Regs. 53.4945-4(b) because of the preference given to family members and relatives of the trust's grantor. This preference is not consistent with exempt status under IRC 501(c)(3) because it serves a private purpose of the grantor rather than a public purpose. In addition, this preference is not a criteria related to the purpose of the educational grant like financial need and academic achievement.

2. Advance Approval for Scholarship Programs

The court case, revenue ruling and PLR discussed below consider whether advance approval of grant procedure is a key element in the taxable expenditure exception for educational grants described in IRC 4945(g), and when an organization may avoid a taxable expenditure even though the Service has not ruled in advance on the grant procedure.

In John Q. Shunk Association, Inc. v. United States, 626 F. Supp. 564 (S.D. Ohio 1985), the court considered whether advance approval was essential for a private foundation to avoid a taxable expenditure when making scholarship grants. The court held that John Q. Shunk Association, an exempt private foundation, was liable for the initial tax under 4945(a)(1) because it awarded scholarships using a selection procedure which had not been approved in advance as required under IRC 4945(g)(1). The fact that the foundation met the other requirements under IRC 4945(g)(1) was not sufficient to avoid classification as a taxable expenditure. The court rejected the foundation's argument that the filing procedure is ministerial and unnecessary to effect the purpose of the statute. Failure to obtain advance approval was a failure to substantially comply with the law, instead of a failure to file a superfluous administrative document. Advance approval is a substantive requirement to ensure objectivity in the grant selection process. Consequently, advance approval is necessary in order to substantially comply with the law.

Rev. Rul. 86-77, 1986-1 C.B. 334, examined the effect of disclosing grant procedures in an exemption application. An exempt private foundation had disclosed its intent to provide scholarship grants and fully described its procedures in its exemption application. After receiving an exemption letter that neither expressly approved nor disapproved the grant procedures, the foundation began to make the grants as described in the application.

The foundation's full disclosure of its grant-making procedures (including all the information required by Reg. 53.4945-4(d)(1)) in its exemption application qualified as a properly submitted request for advance approval of grant procedures under Reg. 53.4945-4(d). The exemption letter did not constitute an approval of its grant procedures because the letter did not address the grant program. Nevertheless, the organization's procedures are considered to have been approved from the application date under Reg. 53.4945-4(d)(3) because the foundation did not receive notice that its procedures were not approved within 45 days of the application date. Consequently, the revenue ruling determines that the foundation's scholarship grants were not taxable expenditures under IRC 4945(d)(3). G.C.M. 39509 (May 29, 1986) considered the same fact situation presented in revenue ruling.

3. Scholarship or Fellowship subject to IRC 117(a)

A majority of the activity with regard to the requirement that a scholarship or fellowship be subject to IRC 117(a) concerns employer-related grant programs. Rev. Proc. 76-47, 1976-2 C.B. 670, provides guidelines for determining whether a grant made by a private foundation under an employer-related grant program to the children of employees qualifies under IRC 117(a). According to the revenue procedure, a program must satisfy seven initial requirements, and then satisfy either a percentage test or a facts and circumstances test. The activity centers around the percentage and the facts and circumstances test.

Under the percentage test, the number of grants in a year to children of employees must not exceed either: 1) 25 percent of the number of employees' children who were eligible, were applicants and were considered by the selection committee, or 2) 10 percent of the number of employees' children who can be shown to be eligible for grants whether or not they submitted an application. Grants to employees may not exceed 10% of the number of employees who were eligible, were applicants and were considered by the selection committee. Under the alternative facts and circumstances test, the revenue procedure considers whether the primary purpose of the grant program is to provide extra compensation or other employment incentive to employees or to educate recipients in their individual capacities. The probability that a grant will be available to any eligible applicant is the key consideration in making this determination. The revenue procedure also provides a separate list of relevant facts and circumstances to consider.

Rev. Rul. 86-90, 1986-2 C.B. 184 considers whether employer-related educational grants planned by an exempt private foundation meet the IRC 4945(g)(1) requirement that they qualify as scholarships under IRC 117(a). The foundation proposes to award one grant per year to a child of an employee of a particular employer with 3,000 employees. The grant meets the first seven requirements in Rev. Proc. 76-47 but will be made without regard to the percentage limitation guidelines of the revenue procedure. Although the foundation believes that it will satisfy the 10% percentage test each year, the foundation will not make the determination because of the expense required in relation to the small amount of the grant.

As an alternative to the percentage test, the revenue ruling determines that the foundation satisfies the facts and circumstances test by showing that the primary purpose of the grant program is to educate recipients in their individual capacities since there is no significant probability that a grant would be available to the child of any particular employee or to a child selected from any particular group of employees. The following characteristics indicate the limited availability: 1) the selection committee is independent of the foundation and the employer, 2) the committee awards grants using the objective criteria of academic performance and financial need, 3) the company's employees and the plan have no unusual characteristics that would cause a specific group of children to receive or not receive a grant, 4) the grants are small in number and amount, and 5) there is no significant limitation on the grantee's choice of a course of study or school. In addition, the revenue ruling agrees that the foundation's inability to demonstrate whether it will meet the 10% test is reasonable because the expense of conducting the test is greatly out of proportion to the small grant program. G.C.M. 39532 (July 16, 1986) also considered the situation discussed in Rev. Rul. 86-90.

In Beneficial Foundation, Inc. v. United States, 626 Fed. Supp. 564 (Cl. Ct. 1985), examined whether private foundation employer-related, educational grants qualified under IRC 4945(g)(1) or (3). Beneficial Foundation, Inc., an exempt private foundation, distributed about 40% of their charitable funds as educational grants to children of employees of Beneficial Companies. The foundation awarded grants on the basis of academic qualifications and financial need for study at approved colleges and universities. The Beneficial Companies (Beneficial Corporation and its subsidiaries), and their officers and stockholders contributed part of the foundation's support.

The court supported the Service's exercise of discretion in determining that the grants were not scholarships or fellowships described in IRC 117(a) as required by 4945(g)(1). In addition to failing the percentage test in Rev. Proc. 76-47, the Service argues that the grant program also failed the facts and circumstances test for the following reasons: a high percentage of the applicants (75%) received awards, the number of awards were substantial, company booklets for employees emphasized the benefits to employees from the program, and the grant program was part of an overall company program to provide scholarships to employees' children. The grants were designed to provide extra compensation or an employment incentive to employees. The court rejected the foundation's complaint that the Service did not consider some of the facts and circumstances in the revenue procedure because the court determined that the factors considered were reasonable and the decision was rational.

The court, however, rejected the Service position that grants did not qualify under IRC 4945(g)(3). The Service argued that the grants were made for a college degree which was too broad of a purpose rather than for an appropriate specific objective (such as conducting scientific research or writing a monograph). The court reasoned that the Service had previously taken the position that obtaining a college education was a sufficiently narrow purpose to satisfy IRC 4945(g)(3) in revenue rulings such as Rev. Rul. 77-434, 1977-2 C.B. 420. This revenue ruling concluded that long-term, low interest loans made by a private foundation, primarily on the basis of need, to enable recipients to attend college qualified under IRC 4945(g)(3). In conclusion, the Tax court required that the Service reconsider whether the foundation qualified under 4945(g)(3) consistent with the court's interpretation of the section.

A 1989 CPE article on page 154 addressed which scholarships and fellowships are subject to IRC 117(a) for purposes of IRC 4945(g)(1). Prior to the Tax Reform Act of 1986, IRC 117(a) grants could include incidental expenses for room, board, travel, research, clerical help, or equipment. The Tax Reform Act of 1986 narrowed the grants covered under IRC 117(a) to include only scholarship or fellowship grants received by a degree candidate to pay for the tuition and the fees at these institutions, plus fees, books, supplies and equipment required for the courses. Notice 87-31, 1987-1 C.B. 475, and a technical correction of TAMRA, however, provide that IRC 4945(g)(1) refers to scholarship and fellowship grants as defined in IRC 117(a) before the changes in the Tax Reform Act of 1986.

D. Expenditure Responsibility

In Hans S. Mannheimer Charitable Trust v. Commissioner, 93 T.C. No. 5 (July 12, 1989), the court considered whether a private foundation exercised expenditure responsibility. The Tax Court held that Hans S. Mannheimer Charitable Trust, a private foundation, was liable for the 10% excise tax under IRC 4945(a)(1) because of taxable expenditures. Although all the funds paid to grantees were spent for the proper purposes, the foundation made taxable expenditures under IRC 4945(d)(4) because it did not exercise expenditure responsibility as defined in IRC 4945(h) when making grants to two related private foundations.

The grantor foundation did not comply with the IRC 4945(h)(1) requirement to assure that grants are spent for the proper purposes because the foundation failed to obtain a written commitment regarding the grants from the grantees and to have a copy of the commitment available at its principal office. None of the documents submitted to the court by the foundation (the agreement of trust, certificates of incorporation, bylaws, minutes, monthly reports, annual reports and information returns) contained the agreements required by Reg. 53.4945-5(b)(3) or were made available for inspection. The grantor did not satisfy the IRC 4945(h)(2) because the foundation did not exert reasonable efforts or establish adequate procedures to obtain complete reports from the grantees on how funds were spent. Finally, the grantor foundation did not meet the IRC 4945(h)(3) requirement to make full and detailed reports to the Secretary regarding its expenditures because the required information was not in the organization's information returns or in a separate statement. The summary statements made in the information returns did not substantially comply with the reporting requirements in the regulations.

The court refused to apply IRC 4945(h) loosely because the provision was intended to tighten the law with respect to private foundations. The expenditure of grant money for the proper purposes and the summary information provided in grantor documents were not sufficient to meet the strict IRC 4945 requirements.