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CORPORATE PRIVATE FOUNDATIONS
CHARITABLE EMPLOYEE HARDSHIP FUNDS
COMPANY FOUNDATION SCHOLARSHIP PROGRAMS

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Corporate Private Foundations Are a Significant Force in Philanthropy

There is considerable overlap between the list of the 50 largest corporate foundations and the largest companies in the Fortune 500.*

- The role played by these foundations in carrying out corporate philanthropy varies considerably:
  - *Some focus on making grants to charitable organizations in communities where the founding corporations have a significant presence*
  - *Some direct their philanthropy to causes that resonate with their work force*
    - Scholarship programs for children of employees
    - Matching gift programs
    - Employee hardship funds for employees with unexpected needs
  - *Some focus on making grants to tackle difficult societal problems*

*/ List of the 50 largest corporate foundation by asset size, total giving, and gifts received may be found at the Foundation Center's website, www.foundationcenter.org.

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Understanding The Relevant Tax Laws is Critical to Successful Corporate Philanthropy

Corporate private foundations are subject to a set of tax restrictions that are not intuitive and carry substantial penalties for violations. These include the following:

- Section 4941 -- self-dealing rules impose penalties on the company for certain transactions with the foundation, even if they are fair or even advantageous to the foundation
- Section 4942 -- payout rules penalize foundations for failing to make minimum annual charitable expenditures of 5% of net investment assets
- Section 4943 -- excess business holding rules penalize foundations for owning more than 20% of the voting stock of an active business
- Section 4944 -- jeopardy investment rules penalize foundations for making imprudent investments
- Section 4945 -- taxable expenditure rules penalize foundations for making certain types of impermissible expenditures

Self-Dealing Rules Under Section 4941 – Excise Tax Liability

Section 4941 imposes the following excise taxes on acts of self-dealing

- 10% initial excise tax on each act of self-dealing between a “disqualified person” and a private foundation
- 200% additional tax if the act is not corrected
- 5% tax on foundation managers who knowingly approve an act of self-dealing, subject to a $20,000 cap on a joint-and-several basis
- 50% additional tax on foundation managers if the act is not corrected, also subject to $20,000 cap on a joint-and-several basis

Self-Dealing Rules – Who Is Subject to Penalties

Self-dealing penalties apply to disqualified persons and foundation managers. There is no self-dealing penalty on the foundation.

- Disqualified persons include the foundation's directors, officers, substantial contributors and certain family members or 35% owned subsidiaries of the above
  - *Disqualified persons also include government officials at certain levels*
  - *Companies are typically disqualified persons with respect to their foundations because they are substantial contributors*
- Foundation managers potentially subject to the penalty for knowingly approving a self-dealing transaction include foundation officers and directors

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Self-Dealing Rules – Acts of Self-Dealing

Acts of self-dealing include:

- Sale, exchange, or leasing of property (other than leases at no cost to the foundation),
- Lending of money (other than interest-free loans to the foundation)
- furnishing of goods, services, or facilities (other than at no cost to the foundation),
- Payment of compensation except reasonable compensation for personal services,
- Transfer or use of the income or assets of the foundation

There is no self-dealing exception for inadvertent violations

- Even transactions that clearly benefit a foundation may be self-dealing   (e.g., a below-market lease from a company to its foundation)

Self-Dealing Rules – Avoiding Foot-faults

The key to avoiding self-dealing transactions is to understand the rules and structure relationships accordingly

- Corporations may provide office space, supplies and equipment to the foundation on a no-cost basis, but the foundation cannot reimburse the corporation for such facilities or supplies
- Foundations may reimburse companies for compensation paid to company employees who provide services to the foundation if such compensation is reasonable
  - *Reasonableness is determined based on the employee's job description at the foundation and not at the company*
  - *Foundation cannot reimburse company for any equity-based compensation to employees who work on foundation matters*

Self-Dealing Rules – Avoiding Foot-faults (cont'd)

  - *Company employees whose salary is partially reimbursed by a foundation must keep time records that substantiate the allocation between the Company and the foundation*
- Company foundation scholarship programs and charitable employee assistance programs must meet special requirements (discussed below) to avoid self-dealing

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Self-Dealing Rules – Incidental and Tenuous Exception

Foundations are permitted to confer “incidental and tenuous benefits” on their related companies

- This includes increased public recognition, foundation-generated publicity, and goodwill -- the “halo” effect derived by the company from the foundation’s philanthropic activities
  - *Foundation sponsorship of charity events for which there is sponsor recognition is permissible*
  - *Foundation sponsorship of charity events for which the company (rather than the foundation) receives a quid pro quo is not permissible*

Self-Dealing Rules – Common Issues

Foundations are not permitted to engage in activities intended to market the products or services of the company, or to result in other tangible economic benefit to the company

- Impermissible -- sponsoring a table at a fundraising event attended by company employees with no ties to the foundation
- Impermissible -- making grants to charitable or governmental organizations, whether inside or outside the U.S., with which the company is seeking a business relationship
- Permissible -- making grants to charitable organizations in communities served by the company; any benefits to the company in the nature of goodwill and considered incidental and tenuous

Self-Dealing and Disaster Relief – In General

Companies can provide disaster relief to employees through a corporate foundation or an employer-sponsored public charity

- Corporate private foundations can only provide assistance to company employees or family members who are victims of "qualified disasters"
  - *Defined as disasters resulting from terrorist acts, Presidentially-declared disasters, and catastrophic events decreed by the Secretary of Treasury*
- Employer-sponsored public charities are much more flexible
  - *Assistance is not limited to employees affected by a "qualified disaster"*
  - *Assistance can be targeted to a wide range of needs*

Benefits to employees from either program are not taxable

Disaster Relief Through Corporate Foundations

Corporate foundations can provide assistance to employees or their family members only if the assistance is in response to a qualified disaster

- Disaster assistance program must apply to an indefinite class and not a predetermined group
- Recipients must be selected based on an objective determination of need or distress
- There must be an independent selection committee, a majority of which cannot include officers, directors or senior executives at the company

Disaster Relief Through Employer-Sponsored Public Charity

Employer-sponsored public charities can provide disaster and other hardship assistance to employees in need

- Assistance is not limited to situations involving “qualified disasters”
- Assistance can be based on individual disasters (house fire, etc), unanticipated medical needs, or other emergencies or hardships
- Program must apply to indefinite class
- Recipients must be selected based on objective determination of need
- Must have independent selection committee, a majority of which cannot include officers, directors or senior executives of the company

Employer-Sponsored Public Charities: Maintaining Public Charity Status

Maintaining public charity status is a threshold and on-going requirement; this requires the organization to receive substantial on-going funding from sources other than the company

- Public support may come from employee donations
  - *Employee donations are the most commonly provided vehicle for employees to help employees*
- Public support may also come from annual fundraising events, such as charity golf tournaments
  - *Fundraising events are also common funding vehicles*
- Public support may come from donations from the company's vendors or customers
  - *Company vendors are often sponsors of fundraising events such as charity golf tournaments*

Meeting the Public Charity Requirement

In general, a 501(c)(3) organization may qualify as a public charity if one-third of the funding comes from diverse sources other than the company/employer

- It is possible for an organization to maintain public charity status with less than one-third non-company funding, depending on whether other facts and circumstances are met.

The one-third test is calculated as follows:

- The denominator includes all income except program service revenue and capital gains
- The numerator includes donations from the company, employees and other sources but each donation is counted only to the extent of 2% of the denominator except donations from other public charities which are not subject to the 2% cap
- The fraction is calculated on a cumulative, rolling five-year basis.

Meeting the Public Support Test – Example

Charity X is an employee assistance fund founded by Company Y. Each year during 2008, 2009, 2010, 2011, and 2012 Charity X received annual funding of $150,000, consisting of $50,000 donated by employees whose individual donations were all $1,000 or less and $100,000 donated by Company Y.

- Denominator (total funding over five year period): $150,000 x 5 = $750,000
- 2% of denominator = $15,000
- Numerator: $265,000 (including $250,000 from employees + $15,000 from Company Y)
- Public support fraction: $265,000/$750,000 = 35.3%

Charity X meets the public support test!

Mandatory Distribution Rules Under Section 4942

Section 4942 requires private foundations to make annual “qualifying distributions” in an amount equal or greater than 5% of net investment assets

Qualifying distributions are defined as expenditures made for charitable purposes

- Charitable purposes include both grants and direct charitable expenditures
- Charitable purposes include reasonable administrative expenses, other than expenses in managing investments

Qualifying distributions do not include grants to certain types of supporting organizations

- Grants to Type III non-functionally integrated supporting organizations do not qualify

Mandatory Distribution Rules Under Section 4942 (cont'd)

- Grants to any supporting organization controlled directly or indirectly by a disqualified person do not qualify

Foundations may seek IRS approval to treat "set asides" for future grants as current qualifying distributions

Excess qualifying distributions made in a year may be carried forward for five years

Mandatory Distribution Rules – Excise Tax Penalties

Section 4942 imposes the following penalties on foundations that fail to meet the annual distribution requirements:

- 30% initial penalty on the foundation on any undistributed income
- 100% additional penalty on the foundation for failure to correct the undistributed income by making the required qualifying distributions after receipt of notice from the IRS

No penalty on foundation managers

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Excess Business Holdings Under Section 4943

Section 4943 prohibits a foundation from owning more than a specified percentage interest in active businesses

- General limit is 20% of voting stock, reduced by any voting stock held by disqualified persons
- Limit is increased to 35% if third parties have effective control
- There is a de minimis exception for ownership of 2% or less
- Definition of “active business” does not include investment funds
- Must look through investment funds to determine the foundation’s proportionate share of the underlying active businesses

Foundations have five years to dispose of excess business holdings acquired by donation

Excess Business Holdings – Excise Tax Penalties

Section 4943 imposes the following penalties on foundations that have excess business holdings

- 10% initial penalty on the value of the excess holdings
- 200% additional penalty if the foundation fails to divest the excess holdings after notice from the IRS
    - *No penalties on foundation managers*

Jeopardy Investment Rules Under Section 4944

Section 4944 prohibits foundations from making "jeopardizing investments"

- Defined as investments made without the exercise of ordinary business care and prudence
- No category of investments is per se considered imprudent
- Investments received as donations are an exception to the jeopardy investment rules and may be retained without risk under Section 4944

Program-Related Investments Under Section 4944(j)

Section 4944(j) carves out an exception from the jeopardy investment rules for “program-related investments” (generally referred to as “PRIs”)

PRIs are defined as investments that meet the following requirements:

- The primary purpose of the investment is to accomplish charitable purposes
- No significant purpose of the investment is the production of income or the appreciation of property
- No purpose of the investment is to engage in lobbying or campaign intervention

PRIs are treated as qualifying distributions in the year made and will increase the annual distribution in the year they are recovered

Example of Program-Related Investment

Foundation X makes a $500,000 loan at 1% interest to Charity Y for the purpose of constructing a day care center in a low-income community.

- The making of the loan is considered a PRI and is not a jeopardy investment
- Foundation X will treat the $500,000 loan as a qualifying distribution in the year made.
- In the year the loan is repaid, Foundation X's annual distribution requirement will be increased by $500,000

Jeopardy Investment Rules – Excise Tax Penalties

Section 4944 imposes the following penalties on foundations that fail to meet the jeopardy investment requirements:

- 10% initial penalty on the amount of the jeopardizing investment
- 25% additional penalty if the foundation fails to correct the jeopardizing investment after notice from the IRS

Section 4944 also imposes the following penalties on foundation managers who knowingly approve jeopardizing investments:

- 10% initial tax of 10%, up to a maximum of $10,000 on a joint-and-several basis
- 5% additional tax, up to a maximum of $20,000 on a joint-and-several basis

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Taxable Expenditures Under Section 4945

Section 4945 prohibits private foundations from making "taxable expenditures," defined as:

- Lobbying expenditures
- Expenditures to influence the outcome of an election or to conduct a voter registration drive
- Individual grants for travel, study, or other similar purpose, unless (1) the grant is awarded on an objective and nondiscriminatory basis, and (2) the grant is made pursuant to a procedure approved in advance by the IRS
- Grants to organizations other than public charities, unless the foundation exercises expenditure responsibility; under the Pension Protection Act, non-functionally integrated Type III supporting organizations are not considered public charities for this purpose
- Expenditures for non-charitable purposes (except to acquire investments)

Section 4945 – Individual Grant Procedures

Section 4945 permits foundations to make grants to individuals, including scholarships and fellowships, as long as the foundation applies for and obtains prior IRS approval of grant procedures for the making of such grants.

- This is a fairly simple process, although it may take some time due to an IRS backlog in the exempt organization area. Foundations must submit procedures showing that there is an objective and nondiscriminatory selection process and that foundations will monitor the use of funds and investigate any suspected diversions.
- Foundations may rely on a "45 day rule" in the regulations to treat grant procedures as approved if the IRS has not responded within 45 days after the application was submitted

Section 4945 – Individual Grant Procedures (cont'd)

- IRS regulations provide that approval of individual grant procedures is intended to be a "one-time" process. Foundations are generally not required to seek further IRS approval for changes to the procedures.

Special requirements apply to company foundation scholarship programs for children of employees

Section 4945 – Company Foundation Scholarship Procedures

Rev. Proc. 76-47 imposes special rules on company foundation scholarship programs for children of employees. Scholarship programs must meet the following requirements:

- Program must not be used as an inducement to recruit employees or induce them to continue employment
- There must be a totally independent selection committee; former employees are not considered independent; awards must be made in the order recommended by the selection committee
- There must be an objective basis for selection
- An award cannot be terminated because the employee leaves employment
- The recipient's course of study cannot be limited to a course of study of particular benefit to the company

Section 4945 – Company Foundation Scholarship Procedures (cont'd)

- In general, awards cannot be made to more than 25% of children of employees who apply for scholarship or 10% of those who would be eligible (whether or not they applied)

Rev. Rul. 81-217 provides that the requirements of Rev. Proc. 76-47 apply even if the company foundation makes a grant to a public charity scholarship corporation, such as the National Merit Scholarship Corporation

- The IRS has developed simplified individual grant procedures for employee-child scholarship programs awarded through the National Merit Scholarship Corporation

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Taxable Expenditure Rules – Excise Tax Penalties

Section 4945 imposes the following excise tax penalties on foundations that make taxable expenditures:

- 20% initial penalty tax on the amount of taxable expenditures
- 100% additional penalty tax if the taxable expenditure is not corrected after notice from the IRS
- The following excise tax penalties are imposed on foundation managers who knowingly approve the making of taxable expenditures
  - *5% initial penalty tax on the amount of taxable expenditures up to a maximum of $10,000 on a joint-and-several basis*
  - *50% additional penalty tax, up to a maximum of $20,000 on a joint-and-several basis*

Reporting and Disclosure Requirements for Private Foundations

Private foundations are required to file IRS Form 990-PF on an annual basis

- Return is due the 15th day of the 5th month after the end of the fiscal year (e.g., May 15th for a calendar year foundation)
- Extensions of up to 6 months are possible

Private foundations are required to make the past three years of 990-PFs available to the public upon request

Form 990-PFs are available on the Guidestar website, www.guidestar.org