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The last Tax Forum introduced the quagmire of new tax law dealing with private foundations. Three of the prohibited transactions were briefly described in the last column—this one will cover the other two private foundation restrictions and will also discuss the additional reporting requirements with which foundation managers will be concerned.

Jeopardy Investments

The Internal Revenue Code has, since 1950, denied tax exemption to a 501(c)(3) organization for any year in which the organization invested its *income* in a manner which would jeopardize the carrying out of the organization's charitable or other exempt purpose. Section 504, which contained this provision, was repealed by the Tax Reform Act of 1969; in its place, new Section 4944 imposes one of the penalty taxes on the investment of any amount, whether it be corpus or income, which might be a jeopardy investment.

Never has Congress, the courts, nor the Treasury Regulations ever shed a great deal of light on what constitutes an investment which jeopardizes the charitable status of an organization. The Committee Reports suggest that speculative type investments such as commodity futures, options, warrants, and the purchase of securities on margin would be suspect for the purposes of this Section. The new Section does not permit the Internal Revenue Service to look back at the performance of a security and then determine that the tax should be imposed. The determination is to be made at the time the investment is made, using a "prudent trustee" approach.

There is an exception in Section 4944 for investments which are program-related—that is, investments which are primarily for charitable purposes, not for production of income or asset appreciation. Examples of such investments are interest-free educational loans, high risk investment in low-income housing, and loans to small business where no commercial sources are available. This assumes that highly profitable investments are not normally charitable in nature.

The pattern of taxation on this type of prohibited transaction follows that imposed on the other types. The first level or initial tax is imposed at the rate of 5 percent on the amount of the investment for each year, or part of a year, that the jeopardizing investment is held. The tax is not only imposed upon the foundation, but also on any foundation manager who participates, in the acquisition of such an investment *knowing* that it will jeopardize the carrying out of the foundation's exempt purposes. If a foundation manager can show that he relied on the advice of an outside, independent investment counselor, he probably can escape liability under the standards currently in effect for applying similar type penalties.

An additional tax of 25 percent of the amount of the prohibited investment will be imposed on the foundation if it fails to divest itself prior to the correction period provided. The IRS has some discretionary power with respect to assessing this additional tax and to determining the correction period. This will allow the state attorney general to intervene to correct the situation if necessary. The second level tax on the foundation managers is left at 5 percent and will be imposed on any manager who attempts to prevent the foundation's divestiture of the offending investment.

Willful and flagrant violations will result in the termination tax discussed in the January 1971 Tax Forum and more fully described below.

Taxable Expenditures

Prior to the Tax Reform Act, Section 501(c)(3) organizations were not permitted to participate in any way in political campaigns, nor could a substantial part of their activities consist of lobbying or attempting in other ways to influence legislation. These provisions are still applicable to any organization attempting to obtain a tax exempt status. In addition, private foundations are now subject to initial taxes at the rate of 10 percent on certain types of expenditures. A foundation manager who willfully participates in one of the prohibited expenditures is subject to an initial tax of 2½ percent on the amount of the expenditure.

The term taxable expenditure is defined in new Section 4945 as any amount paid or incurred by a private foundation for any of the following purposes:

(1) To carry on propaganda or otherwise attempt to influence legislation. The activities which this particular prohibition encompass are specifically spelled out in Section 4945 and include expenditures for influencing the general public, as well as expenditures for communicating directly with members of legislative bodies

and/or government agencies. This provision does not preclude the publication of the results of nonpartisan analysis, study, and research, nor does it preclude the expenditure of funds for appearances at hearings or communication with legislative groups where the existence of the foundation itself is at stake.

(2) To influence the outcome of specific elections or to carry on voter registration drives. This does not apply to organizations such as the League of Women Voters, providing the organization is a 501(c)(3) organization and its efforts are nonpartisan, are carried out over a wide area of at least five or more states, and are continued over more than one election period. If contributions for voter registration drives are received by an organization in this category, they must not be for specific political areas.

(3) As grants to individuals for travel, study, or similar purposes, except where the grant is awarded on an objective and nondiscriminatory basis in accordance with a procedure which has been approved by the IRS in advance. Temporary regulations have been issued in connection with this provision of Section 4945 allowing taxpayers to use any procedure through June 30, 1971, so long as there is demonstrated a good faith effort to provide the required objectivity and nondiscrimination.

(4) As grants to organizations other than public charities. This provision effectively prevents one private foundation from making a grant to another private foundation unless the granting foundation exercises full and complete control over the manner in which the funds are spent by the grantee. This expenditure responsibility is going to increase substantially the record-keeping required for private foundations and is therefore discussed in some more detail below. It is imperative that any private foundation which has been making grants to other organizations during 1970 establish the current tax status of its donees.

(5) For expenditures for any non-charitable purpose. If the taxable expenditure is not corrected within the prescribed correction period, there is a 100 percent tax on the amount of the expenditure imposed on the foundation and a 50 percent tax on the expenditure imposed upon the foundation manager. With respect to taxable expenditures, correction means to recover the money from the grantee to the extent possible; the correction period runs from the date of the expenditure until 90 days after the date a deficiency notice is mailed, subject to extensions.

Reporting Requirements

This is the last year that a private foundation which was already in existence on January 1, 1970, can maintain its exempt status unless it amends its governing instrument to provide for current distribution of income in accordance with Section 4942 and to prohibit the acts which give rise to taxes under Sections 4941, 4943, 4944, and 4945. Temporary regulations adopted in May 1970 provide that amendments will not be necessary if state laws are enacted specifically prohibiting the taxable transactions enumerated in the above mentioned sections or if state laws are enacted which treat the required provisions as though they were already included in the foundation's governing instrument. Since state legislatures are seldom known to act with great speed, it would appear to be advisable to amend the foundation's governing instrument. However, state laws may in some cases prevent the inclusion of some of the required provisions, in which case the foundation may have to do some lobbying just to preserve its own existence.

Foundations organized after January 1, 1970, will not be entitled to exemption, nor will they be eligible for deductible contributions until they have a governing instrument which satisfies the requirements of the Act. These provisions are in Code Section 508(e).

In connection with the filing of Form 990-A (the exempt organization information return), private foundations are also required to file an annual report. Copies of the annual report must also be made available to state officials and to any other persons designated by the IRS Regulations. In addition, the foundation manager must also publicize in a newspaper that the foundation's annual report is available for inspection at the foundation's principal office. The information required by the annual report is set forth in Section 6056. A great deal of it is financial information similar to that which has always been required on Form 990-A, but there are some additional requirements which will help give accountants more job security. An itemized statement of the foundation's securities and any other assets at the close of each year, showing both book and market value, will be required. Another new requirement is an itemized list of all grants and contributions made or approved for future payment during the year, showing the amount of each grant, the name and address of the recipient, any relationship between the recipient and the foundation managers or substantial contributors, and a statement of the purpose of each such grant. Also required is a list of foundation managers who are also substantial contributors.

One of the greatest burdens required of foundations which have been in existence for any length of time will be the determination of substantial contributors as of October 9, 1969. Since the substantial contributor status is cumulative, records of all gifts and bequests since the inception of each private foundation must be reconstructed and maintained on a continuing basis. For most purposes, a substantial contributor is any person who has contributed an aggregate of $5000 if such amount is more than two percent of the total contributions received before the end of the taxable year in which the contribution is received. For purposes of this definition, a man and his wife are one person.

Another burdensome record-keeping responsibility will be that of keeping track of the disqualified persons together with their family interests in corporations, trusts, and partnerships. Also, it will be necessary to maintain very careful and current records with respect to the holdings of any foundation where there are disqualified persons who hold the same interests.

Foundation expenses will have to be allocated in such a manner that clear visibility is given to investment income and related deductible expenses subject to the 4 percent tax, unrelated business income and expenses deductible for determining that tax, and expenses incurred in carrying out charitable programs which will qualify in establishing the minimum distribution required under Section 4942.

Much of this required record-keeping and reporting involves information far outside the scope of what accountants believe should normally be included in an adequate record system. One of the most "far out" requirements is that of expenditure responsibility which must be exercised with respect to grants by one private foundation to another. Section 4945(h) requires that a private foundation making such grants is responsible for making every effort, and establishing adequate procedures, to ascertain that the grant is spent exclusively for the purpose for which made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports to the IRS. Therefore, it will first be necessary for each private foundation to establish the status of each organization to which it makes donations. Many organizations which are not private foundations have voluntarily sent a copy of their notification to the IRS on Form 4653 to each of their donors. If a donee organization does not provide the necessary information to the donor organization, then the donor organization must obtain a legal opinion of the status of the donee organization. Donee organizations wishing to continue to receive grants from other organizations can no doubt be persuaded to furnish the necessary information. One can't help but wonder if the reporting requirements in themselves will not jeopardize the foundation's capability to continue to carry out its exempt purposes.

Some private foundations will no doubt throw in the towel and decide termination is the only answer. A brief look at Section 507 rapidly establishes that the private foundation is on a treadmill from which it is difficult to escape. Significantly, the Tax Reform Act of 1969 began with Section 507 entitled "Termination of private foundation status". Not until Section 509 does it even attempt to define what it is terminating in Section 507. Typical of the language in this Section 509 is the sentence, "For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c) (3)." One wonders whether the private foundation can even self-destruct provided it ever figures out what it really is!

HUMAN ASPECTS OF BUDGETING

(Continued from page 8)

budgets and performance reports is to have a member of the budgetary staff explain to production personnel the use and need for budgets. Accountants need to persuade the users of data that accounting reports really exist to aid the manager in doing a better job. The interpretative roles such as explaining variances between actual and budgeted data should be manned by capable experienced accountants who can talk in the line manager's language. These interpreters are the individuals who will establish the status of the controller's department in the company.

Factory personnel are not the only individuals who need additional training. Budget people should also be given a thorough course in self-understanding and getting along with others. The training should be focused to help finance people perceive the human implications of budgets. The budgetary accountants should understand the effects of pressure upon people. The accounting staff should be helped to perceive their difficult position of placing others in positions of failure. They should be aware of the practical techniques which the finance staff can use to get along better with factory personnel. Finance people should also be helped to see the department centerness of supervisors as a defense on the part of the factory supervisors rather than as narrowmindedness. Only when both production and accounting personnel understand each other's position and are willing to cooperate will the maximum success of a budgetary program be achieved.