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Tax Forum

Private Foundations — "A Bear By The Tail"

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GUEST WRITER: This column was written by Ann Moody, CPA, Trust Tax Officer in the Trust Department of the First Alabama Bank of Birmingham.

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The advent of the 1969 Tax Reform Act found many private foundation managers "holding a bear by the tail", especially those who were not right on top of the law. The law allowed them a limited period of time to comply, but the provisions were vague and complicated to follow, almost as if the legislation were intended to do away with private foundations.

Now, after a few years of working with the changes, many who are responsible for private foundations have concluded that termination is the best answer to their many problems. This is why they may be said to have a "bear by the tail". It is difficult to operate a private foundation under the law, but it is no easy matter to terminate one.

Sample Situation

Assume a private foundation was in operation prior to the '69 Tax Reform Act. Its origin stems from a community-wide vaccination program, with those receiving vaccinations making a small contribution to cover costs of serum, doctors, nurses, and other costs of administering the program. However, druggists in the community donated serum, and doctors and nurses contributed their time, so that after payment of remaining expenses, many dollars remained from the contributed funds. This money was used to establish a trust, the income to be used for paramedical training.

After the 1969 Tax Reform Act, the Board of Trustees amended the Articles of Incorporation to provide that the trust should make no taxable expenditures "as defined in Section 4945(d) of the Internal Revenue Code of 1954 or corresponding provisions of any subsequent Federal Tax Laws". Aware that the law is complex and ever-changing, they recently requested advice concerning their compliance.

Scholarship Loans to Individuals

The private foundation board specifically asked if they were "safe" making scholarship loans to individuals for paramedical studies. They were not. They had not received prior approval from I.R.S. concerning their procedure, and loans for educational purposes fall within the definition of "grants" to individuals for study in Reg. 53.4945-4(a)(2), and are, therefore, taxable expenditures.

Outright Grants vs. Loans

They also asked if the foundation could change its policy from making loans to making outright grants; and if so, what would be the procedure. Of course the proper procedure is to make the grants pursuant to a procedure approved in advance by Internal Revenue. Contents of the request for approval are set out in Reg. 53.4945-4(d) in detail, but briefly stated, this request should describe fully the foundation's procedure in awarding the grants and for follow-up to ascertain that they were used for the proper purposes. If the organization is not notified by the 45th day after submitting the grant procedures that they are not acceptable, they are considered approved from the date of submission until notice that the procedures are *not*, in fact, acceptable.

The foundation must satisfy the commissioner that the grant procedure's selection process is objective and nondiscriminatory; that the grants are being used by the grantee for the activities the grants are intended to finance; and that the foundation plans to obtain reports to this effect.

If the grants are made directly to indi-

viduals to be used for a specific objective, to produce a report or other similar product, or to improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill or talent, the private foundation must require reports on how the funds are used and the progress made by the recipient at least once a year. When the purpose for which the grant was made is achieved, a final report must be made describing the grantee's achievement and accounting for the funds received.

The foundation must receive a report of any courses taken by the grantee of scholarship and fellowship grants and any grades. The report must be verified by the educational institution and obtained at least once a year. If study involves research rather than courses taken for grades, the foundation must receive at least annually a progress report approved by the faculty member supervising the grantee, or by another appropriate official. A final report is also required.

If the periodic reports indicate that funds are being used for other than the grant's purpose, the foundation must investigate. If reports are delinquent or are not received by the foundation, further payments are to be withheld until the situation is corrected. If funds are diverted, steps must be taken to recover them and avoid further diversions.

Records to be retained by the private foundation, in addition to records concerning the above, include all information the foundation obtains for evaluation of qualifications of prospective grant recipients; identification of grantees, including relationship to the foundation; and the amount and purpose of each grant.

Contributions to County Medical Society

The foundation's next question was whether they could make contributions directly to the County Medical Society for their distribution to grant recipients.

If the County Medical Society is an organization exempt under Section 501(c) (3) of the Internal Revenue Code, gifts and grants made to it which are, in turn, used to make grants to an individual will generally not be considered taxable expenditures provided that:

(1) The funds are paid directly to the public charity (County Medical Society in this case).

(2) The project is to be conducted under the supervision of a public charity, and

(3) The public charity participates in the selection of the individual involved.

The foundation cannot "earmark" the use of the grant for any named individual and there must not exist "an agreement, oral or written" whereby the foundation may cause the selection of the individual grantee. Nor can the grant be "earmarked" for any prohibited activity. However, it appears the foundation could specify how the funds should be used so long as this use is not the carrying on of propaganda, influencing legislation or other prohibited activities.

Termination Considerations

By now, the board members were having thoughts of going the way of many other private foundations since 1969 — termination. But how? Under Section 507(a) of the Code, private foundations may be terminated voluntarily by notifying the Secretary or the Secretary's delegate of this intention and payment of the termination tax. However, special rules in Section 507 (b) of the Code allow relief from the liability of the termination tax (which can become rather sizeable.) If the foundation has not willfully committed acts or has not willfully failed to do certain things which would give rise to tax liability under Chapter 42, it shall be terminated if:

(1) It distributes all its net assets to one or more exempt organizations described in Section 170(b) (1) (A) which have existed for a period of at least 60 calendar months immediately preceding such distribution, or

(2) It notifies the Secretary or the Secretary's delegate that it wishes to terminate private foundation status and then for a continuous period of 60 calendar months beginning with the first day of any taxable year, it operates as an organization not a private foundation as set out in Section 509(a) (1) (2) or (3). The Foundation must then satisfy the Secretary or delegate immediately after the 60-month period that it has complied.

If the first alternative is chosen, the foundation finds the code's requirements fewer and easier to follow, and termination by bulk distribution to a public charity does not require advance notice to the Commissioner.

However, if it goes the second route and converts into a public charity, the organization can continue its existence and will allow for more control over future use of the foundation's assets.

Sections 509(a) (1) and (2) are usually difficult and/or impractical to consider in terminating private foundation status. Section 509(a) (1) Public Charities include churches, educational institutions, hospitals, and medical research organizations, organizations substantially supported by a governmental unit or the general public. As complex as this sounds, it is even more complex trying to meet the criteria set out in the regs.

Section 509(a) (2) Public Charities must normally receive more than one-third of their support from other than disqualified persons and from Section 509(a) (1) Public Charities and normally receive not more than one-third of their support from gross investment income. Again, detailed requirements are very complex.

Section 509(a) (3) is somewhat less complicated, so that an organization can terminate private foundation status by becoming a Section 509(a) (3) Supporting Organization, organized, operated, supervised, and controlled by or in connection with and exclusively for the benefit of one or more Section 509(a) (1) or (2) Public Charities and not controlled by disqualified persons. Although still complicated, and almost invariably requiring amendment of the governing instrument of the organization, this is probably the most likely solution.

Conclusion

The foundation studied plans termination under Section 509 (a) (3), becoming a supporting organization for a tax exempt hospital, because it does not wish to cease its existence and actually distribute its assets to an exempt organization.

Whatever the route of termination, it is complex and difficult. So is continuation. Whatever decision is made by a foundation, it is very important that any action be carefully contemplated before proceeding and that it be according to the rigid provisions of the code, remembering that the penalties and additional taxes are many and severe and that they may be applicable to foundation managers as well as to the foundation itself. Certainly after the 1969 Tax Reform Act, those involved with private foundations do, indeed, have "a bear by the tail".