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NEW DEVELOPMENTS AFFECTING PRIVATE FOUNDATIONS

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APRIL 22, 1999

I. INTRODUCTION

A. IN 1950:

Year	private foundations	all charities
1950	2,000	50,000
1999	46,000	1,140,000 (600,000 of which are required to report to IRS)

B. IN 2000:

Thanks to America's longest period of private wealth accumulation, Americans are experiencing the largest intergenerational transfer of wealth in history. Estimate: $225 billion per year until 2040. Prediction: Formation of more family foundations than at any time before in history.[2]

C. FOUNDATION CENTER DATA:

1. In 1996, there were *41,588* active grantmaking foundations in the United States.

2. Of those *29.5%* or *12,259* held assets of $1 million or more or made grants of $100,000 or more per year.[3]

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1 The author appreciates the assistance of Katharine Moir, an associate at Simpson Thacher & Bartlett, in preparing this outline. All section citations are to the Internal Revenue Code of 1986, as amended.

2 Bruce Sievers and Kirke Wilson, "Our Half Century," 40 Foundation News and Commentary, March/April 1999, at 32ff.

3 "Five Decades of Foundation Births," 40 Foundation News and Commentary at 72.

D. THE TAX REFORM ACT OF 1969, INCLUDING CHAPTER 42 OF THE INTERNAL REVENUE CODE, IS 30 YEARS OLD IN 1999.

II. PRIVATE FOUNDATION PROVISIONS IN THE OMNIBUS CONSOLIDATED AND EMERGENCY SUPPLEMENTAL APPROPRIATIONS ACT

Congress recently passed the Omnibus Consolidated and Emergency Supplemental Appropriations Act (the "Act"). The Act contains two provisions of interest to private foundations and their donors, which are summarized below. The Act was signed into law on October 22, 1998.

A. CONTRIBUTIONS OF QUALIFIED APPRECIATED STOCK

In general, the amount of the deduction for a contribution of appreciated stock to a private foundation is currently limited to the amount equal to the donor's basis in the stock. However, a special rule allows a deduction equal to the fair market value of "qualified appreciated stock" contributed to a private foundation. This special rule was enacted in 1984, expired in 1994, and was periodically extended and allowed to expire. The special rule had expired on June 30, 1998. The Act permanently extends the special rule, which will avoid the recent annual anxiety about expiration and extension.

For purposes of the special rule, the term "qualified appreciated stock" means stock:

- for which market quotations are available on an established securities market,
- which is capital gain property in the donor's hands, and
- in a company of which the donor and any family member will have contributed less than 10% in value, counting prior contributions. For these purposes, a "family member" includes a brother, sister, spouse, ancestor or lineal descendant.

The permanent extension of the rule is retroactive to all contributions of qualified appreciated stock to private foundations made on or after July 1, 1998.

B. PUBLIC INSPECTION OF PRIVATE FOUNDATION ANNUAL RETURNS

Private foundations will be subject to new public inspection requirements that have been enacted, but which are not yet effective, for public charities and all other tax-exempt organizations that file annual information returns. In summary, a private foundation will be required to make available for inspection its annual information return (IRS Form 990-PF) for any of the three most recent taxable years and its application for recognition of exemption (IRS Form 1023) and related correspondence (if it had Form 1023 on July 15, 1987, and for all private foundations that filed after that date). These materials must be made available at a foundation's principal office and any regional or district office having three or more employees. In addition, a private foundation will be required to provide copies, upon request, of these materials. If the request for copies is made in person, a private foundation will have to provide the copies immediately; if the request is made in writing, a private foundation will have thirty days to comply. In either case, a private foundation may charge only a reasonable fee for reproduction and mailing costs. The proposed regulations would allow a private foundation to charge $1.00 for the first page and $.15 for each subsequent page plus actual postage, although these amounts may change when final regulations are published.

A private foundation will be relieved of these public inspection and copying requirements if, in accordance with regulations to be issued by the Secretary of the Treasury, it has made the requested documents "widely available," or the Secretary of the Treasury has determined, upon the organization's application, that it was subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest. One way to make these documents widely available will be by posting them on the foundation's World Wide Web page on the Internet. Other methods are likely to be included in the final regulations, when published. It is not clear at this time whether a foundation's return being available at the Foundation Center libraries will satisfy part of the "widely available" test.

When complying with a request for inspection of materials, a private foundation is required to disclose the name of every substantial contributor. (This is noteworthy because public charities are *not* required to disclose the names of their contributors.) Also, private foundations will no longer be subject to the special publication requirements of Internal Revenue section 6104(d). This provision requires that a private foundation publish a notice, in a newspaper having general circulation in the county where the foundation's principal office is located, stating that its annual information return is available for public inspection upon request and providing certain contact information.

These provisions will apply to requests made after the date that is 60 days after the Treasury Department issues final regulations for private foundations defining when requested documents have been made widely available or when a request is part of a harassment campaign. Although final regulations have been issued for public charities regulations have not yet been published with regard to private foundations. Final regulations for public charities are effective June 8, 1999.

C. SUMMARY

In practical terms, the results of the change include:

(1) After the effective date applicable to private foundations, private foundations will no longer need to publish a newspaper announcement regarding public availability.

(2) Private foundations can expect requests for public access to their applications for exempt status on IRS Form 1023.

(3) Both public charities and private foundations will be subject to the same rules (except for private foundations disclosing their contributors) and will be able to meet the "widely available" requirement by Internet postings of returns and Forms 1023.

III. IRS WORK PLAN

The IRS 1999 Priority Guidance Plan released March 11, 1999, included two private-foundation items: Item 3-Guidance under section 507 regarding termination of private foundation status and Item 11-Guidance under section 6104 regarding the disclosure of certain documents by private foundations.

IV. HOW A PRIVATE FOUNDATION CAN USE "FRIENDS OF" ORGANIZATIONS

U.S. private foundations are increasingly involved in international grant-making. One way for a private foundation to give overseas is to make direct grants to foreign charities. Many U.S. private foundations, however, may want to consider giving overseas indirectly through a "Friends of" organization.

A. WHAT IS A "FRIENDS OF" ORGANIZATION?

The term "Friends of" derives from the fact that the names of so many organizations that support foreign charities begin with these two words. They include organizations such as American Friends of the Canadian Centre for Architecture and Friends of China Heritage Fund, as well as hundreds of other organizations which do not have names beginning with these two words, such as Doctors Without Borders/Medecins Sans Frontieres. The "Friends of" organization is almost always a U.S. nonprofit corporation.[4] It can be classified as a public charity or as a private foundation. A private foundation donor will prefer to give to a "Friends of" organization classified as a public charity in order to avoid having to perform expenditure responsibility (which is required for grants to other private foundations) and to obtain a qualifying distribution under section 4942.[5]

A "Friends of" organization generally exists to provide federal tax deductibility for charitable contributions to support a named foreign charity by breaking a "conduit" flow of

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[4] A corporation seeking a corporate income tax deduction for a charitable contribution is also subject to a requirement that the contribution be used exclusively within the United States or its possessions. § 170(c). (All section references are to the Internal Revenue Code of 1986, as amended (the "Code")). However, a corporate contribution to a charity organized as a corporation avoids this requirement. Rev. Rul. 69-80, 1969-1 C.B. 65. Thus, a "Friends of" organization must be organized as a corporation if it plans to solicit deductible contributions from corporate donors.

[5] § 4945(d)(4).

funds to the foreign charity.[6] While a private foundation has no need of tax deductibility, it may wish to work with a "Friends of" organization to make international grants without extensive documentation and to obtain a qualifying distribution deduction under section 4942. Private foundations must also avoid earmarking of grants[7] and are thus interested in the proper functioning of a "Friends of" organization.

The Internal Revenue Service has approved two structures, which provide models for two distinct types of "Friends of" organizations.[8] The first type of organization makes grants to a foreign charity, and the second actually controls the operations of the foreign charity. In either case, the structure will succeed or fail on the U.S. charity's exercise and documentation of "discretion and control."

B. DISCRETION AND CONTROL.

Directors. The IRS has noted the importance of the "Friends of" organization having a significant number of directors who are U.S. citizens and who are not acting on behalf of the supported foreign charity.[9] This issue is usually handled by negotiation with the IRS after the organization files its application for tax exemption. Board composition may be one of the most difficult issues in setting up a "Friends of" organization unless the foreign charity understands U.S. law. Counsel will likely need to disclose in the application for tax exemption (i) the number of directors that are U.S. citizens or residents and their percentage of the entire Board of Directors, (ii) whether the directors are subject to voting or other restrictions, and (iii) whether the directors are also directors, officers, or employees of the foreign charity. It is also important to take into account state conflict-of-interest rules and watchdog agencies' rules about disclosure and eligibility to vote on grants to an organization of which a director is a director, officer, or employee. In particular, representatives of the foreign charity receiving grants may, for various reasons, take offense at being asked to leave the board room during a discussion or vote. This can be one of the most divisive issues faced by a "Friends of" Board.

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6 An individual or a corporation will not be eligible to claim a U.S. tax deduction for a direct charitable contribution to a charity organized under foreign law. §170(c)(2). Moreover, if a donor makes a gift to a U.S. charity and unconditionally earmarks the gift for a foreign charity, then the gift may be characterized as being made to the foreign charity through the U.S. charity acting as a conduit, and no deduction will be allowed. A properly organized and operated "Friends of" organization avoids the conduit problem by exercising discretion and control over contributions made by U.S. taxpayers.

7 Treas. Reg. § 53.4945-5(a)(6).

8 Rev. Rul. 63-252, 1963-2 C.B. 101.

9 Rev. Rul. 66-79, 1966-1 C.B. 48. An interesting exception is found in Priv. Ltr. Rul. 9129040 (April 23, 1991), where the IRS granted approval to an organization with seven directors, three of whom had to be approved by the foreign charity, where two of the three had to approve all major decisions.

C. GRANTS FOR SPECIFIC PROJECTS.

The models approved by the IRS fund specific projects of the foreign charity. Disapproved models remit net proceeds of fundraising campaigns or "receive contributions and send them at convenient intervals to the foreign organization," which could be interpreted to prohibit general operating support grantmaking. The IRS has held that a charity had to know, in advance of making a grant, what the foreign charity would do with the funds.[10] The problem with general operating support grants is that the "Friends of" organization cedes expenditure control to the foreign charity.

D. PROMISES THAT KILL DISCRETION AND CONTROL.

The donor private foundation should not request, and the "Friends of" organization must not make, promises that the contribution will absolutely, positively be used overseas as the donor requires. The "Friends of" Board must have the option to say "No" if, for example, the "Friends of" organization becomes aware that the foreign charity is diverting funds or failing to account for funds. An alternative is that a donor could pledge a contribution to the "Friends of" organization contingent upon that organization's preapproval of a specific project. In this way, the contingency would not be satisfied and the funds not due unless the project is approved. While the pledge model comes in several varieties and may not be fail-safe, it can be a useful alternative for a donor who wants some level of assurance but wants to avoid earmarking.

E. PREAPPROVE PROJECTS BEFORE SOLICITING FUNDS.

In the model approved by the IRS, the "Friends of" organization solicited funds "pursuant to grants previously reviewed and approved by the Board of Directors." This fact pattern has generally been read to create a preapproval requirement before solicitation begins in the United States. This requirement can be met by using the pledge option described above. An alternative is to ask the foreign charity annually to submit its "wish list" of projects for the following fiscal year. The Board of Directors of the "Friends of" organization can then review and "pre-approve" those projects that they believe will be of greatest interest to U.S. donors. The Board can also authorize and conduct fundraising for these projects in cooperation with the foreign charity. Note that the "Friends of" organization should be the solicitor as it, and not the foreign charity, is likely registered to solicit in the many states that require registration.

F. RECORDKEEPING.

The "Friends of" organization should prepare form proposals, form resolutions, form grant contracts, and form reports if necessary to create the required records that discretion and control have been exercised by the U.S. Board of Directors in proper sequence. Creating a

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10 GCM 35319 (April 27, 1973)

package of form documents also helps the foreign charity better to understand what is expected of it and to avoid misunderstandings or resentment about paperwork. The "Friends of" organization should also create a file for each grant that includes a copy of the board resolution authorizing solicitation, a copy of the resolution authorizing payment of the grant, the grant application and budget from the foreign charity, the grant-award contract, and the annual and/or wrap-up reports.

A grant to a well-run "Friends of" organization can be an efficient means for funding overseas projects without having to conduct expenditure responsibility and permitting credit for a qualifying distribution under 4942. In addition, the donor private foundation has no affirmative legal obligation to investigate a "Friends of" organization's anti-conduit procedures. It will however want to refrain from overriding those procedures, such as by earmarking grants. A better course is to fund preapproved projects of the "Friends of" organization. Finally, a donor private foundation should avoid making grants to those few "Friends of" organizations that the IRS has explicitly ruled to be conduits.[11]

V. SIX RECENT PRIVATE FOUNDATION RULINGS OF INTEREST

A. PRIVATE LETTER RULING 199914040 (APRIL 16, 1999) (SELF DEALING AND TAXABLE EXPENDITURE).

The IRS ruled that a private foundation's disaster relief and emergency hardship program will give rise to self dealing and taxable expenditure excise-tax penalties under sections 4941 and 4945 because the program benefits employees of the corporations which are substantial contributors to the private foundation. This ruling reverses the favorable holding of a 1995 ruling (PLR 9516047). The eligible class of recipients for the program benefits exceeded 40,000 persons who are victims of declared federal, state, or local disasters such as fires, floods, hurricanes, tornados, acts of war, and similar events. The disaster assistance could include cash or in-kind goods such as food, clothing, generators, outdoor grills, and supplies.

In reaching a negative conclusion, the IRS found that the hardship program provided the donor corporation and its subsidiaries with more than incidental and tenuous benefits, especially production of a more stable and productive work force. The IRS also found that the grants and loans paid did not accomplish a charitable purpose.

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[11] For example, on April 23, 1993, the IRS released a determination letter in which the IRS concluded that a foundation qualified as a tax-exempt public charity but that donations to it would not qualify for deduction because the Foundation acted as a conduit to a foreign organization.

B. PRIVATE LETTER RULING 9844033 (OCTOBER 30, 1998) (RARE SECTION 4943 RULING)

In PLR 9844033, the IRS ruled that United States and foreign holding companies formed by a foreign private foundation to facilitate investments in United States and foreign buyout funds would not be classified as business enterprises for purposes of section 4943 taxes on excess business holdings. A foreign charitable trust classified as a private foundation intended to invest in United States and non-United States partnerships engaged in venture capital and other securities investment activities (the "funds"). To ease certain withholding obligations of the United States funds, the private foundation proposed to hold its interest in the United States funds through tax-transparent United States entities wholly-owned by the private foundation. In addition, to shield its assets from unlimited liability in certain jurisdictions, the private foundation intended to hold its interests in the foreign funds through wholly-owned foreign holding corporations. The IRS ruled that, for purposes of section 4943, the United States and foreign holding companies would not be deemed business enterprises. In addition, the determination whether the private foundation held excess business holdings would be made by reference to the proportionate share of any interests in a business enterprise held by each fund in which a holding company held an interest.

C. PRIVATE LETTER RULING 9852023 (SEPTEMBER 28, 1998) (SECTION 4940 RULING —MATTER OF FIRST IMPRESSION)

The IRS ruled that a public charity which was a supporting organization, which was to be converted to a private foundation, would have five years to dispose of business holdings before implicating the excess business holdings rules applicable to private foundations. This transaction was caused by a hospital conversion. The public charity served as the parent corporation of several subsidiaries, including a for-profit health maintenance organization, several medical centers, a physician practice management company and a captive insurance company. The charity proposed to sell the bulk of its business operations and become a grant making charitable foundation, which would be classified as a private foundation. As a result of the charity's change in status, it would be required to dispose of certain of its business operations in order to avoid certain excise taxes imposed on private foundations.

The IRS ruled that (i) the charity would continue to be a supporting organization described in section 509(a)(3)[12] until all of its medical centers were dissolved or ceased to be described in section 509(a)(2), (ii) on the date the charity ceased to be treated as a public charity, the adjusted basis of stock and assets the gain on sale of which would be subject to tax under section 4940(a) would be the fair market value on the date the supporting organization becomes a private foundation, (iii) the charity's investment in its captive insurance captive program would be treated as a program-related investment during the time it retained the obligation to fund liabilities arising prior to the conversion, (iv) the charity would be eligible for the phase-in

[12] All section citations are to the Internal Revenue Code of 1986, as amended.

of the distributable amount under Treas. Reg. 53.4942(a)-3(b)(4) of the Income Tax Regulations, (v) the stock of certain of the charity's for-profit subsidiaries would be treated as having been acquired other than by purchase within the meaning of section 4943(c)(6), notwithstanding any capital contributions by the charity to such subsidiaries, (vi) the stock of the charity's for-profit subsidiaries would not be treated as jeopardizing investments within the meaning of section 4944(a) and (vii) capital contributions made to the charity's physician practice management company after the conversion would not constitute jeopardy investments.

D. PRIVATE LETTER RULING 9834033 (AUGUST 21, 1998) (LLC AND SECTION 4942)

In this ruling, a private foundation and a public charity planned to form a limited liability company to provide family support services. The limited liability company was to be actively engaged in providing family services and was not expected to generate any significant financial return for its investors. The private foundation and the public charity each planned to own fifty percent interests in the limited liability company. Although the limited liability company's governing agreement contemplated additional future investors, the private foundation and the public charity were to control the operations of the limited liability company at all times. The IRS ruled that the private foundation could treat fifty percent of the limited liability company's disbursements as qualifying distributions made directly for the active conduct of the private foundation's activities. In addition, the IRS ruled that capital contributions to the limited liability company would be direct qualifying distributions under section 4942(g) because they constituted program related investments under section 4944(c).

E. PRIVATE LETTER RULING 9831026 (JULY 31, 1998) (SELF DEALING)

The IRS determined that a transfer of a limited partnership interest in a real estate partnership to a private foundation would not constitute self-dealing or indirect self-dealing under section 4941. In addition, the IRS ruled that the private foundation's acquisition of the partnership interest would not constitute a jeopardizing investment under section 4944, nor would the excess business holdings tax apply. The private foundation, a trust, was the charitable beneficiary of two charitable lead trusts. The charitable lead trusts transferred the partnership interest to the private foundation in satisfaction of a residuary bequest and certain back-payments to which the private foundation was entitled. The private foundation neither assumed nor guaranteed mortgage indebtedness of the partnership existing prior to the transfer.

The IRS ruled that the transfer of the partnership interest would not constitute self-dealing under section 4941(d)(A) because the private foundation did not assume the mortgage indebtedness of the partnership and the mortgage was not placed on the property by a disqualified person within ten years prior to the transfer. Payments by the limited partnership to related parties would not constitute indirect self-dealing because the private foundation, as a limited partner with no voice in the partnership's management, would not be deemed to control the partnership. The IRS ruled that the acquisition of the limited partnership interest would not constitute a jeopardizing investment under section 4944 because the transfer would be treated as a gift from the charitable lead trusts and the private foundation would not assume any indebtedness in connection with the transfer. In addition, the excess business holdings tax under section 4943 would not apply to the private foundation as a result of its interest in the limited partnership because the partnership would derive all of its income from passive sources such as rental activities and investments. Moreover, the IRS determined that expenditures made by the partnership in the ordinary course of business would not constitute taxable expenditures of the private foundation within the meaning of section 4945.

F. PRIVATE LETTER RULING 9826048 (MARCH 31, 1998) (PROGRAM RELATED INVESTMENTS UNDER SECTION 4944)

The IRS ruled that a private foundation's overseas economic development program would qualify as a program-related investment under section 4944(c) and that distributions for the active conduct of such program in an amount necessary to satisfy the income and endowment tests of section 4942(j)(3) would qualify the private foundation as an operating foundation. The private foundation provided financial assistance to privately owned businesses in economically depressed regions of the world to help stimulate local economies and create jobs in those areas. The private foundation planned to make a variety of investments in connection with its program, including loan guarantees, loans and equity investments in businesses and financial institutions in the targeted countries. To administer the program, the private foundation employed a salaried staff with specialized skills and expertise in international economic development.

The IRS ruled that the private foundation's investments in the economic development program would constitute program-related investments and, as a result, such investments would not be considered jeopardizing investments under section 4944. In addition, the IRS ruled that if the private foundation were to make qualifying distributions directly for the active conduct of such economic development program in an amount necessary to satisfy the "endowment test" under section 4942(j)(3)(B)(ii) and the "income test" under section 4942(j)(3)(A) for each of its taxable years, the private foundation would qualify as an operating foundation under section 4942(j)(3). The IRS found that the private foundation's loans, equity investments and guarantees were direct exempt-function distributions because the private foundation maintained "significant involvement" (as defined in section 53.4942(b)-1(b)(2)(ii) of the Foundations and Other Excise Taxes Regulations) in its economic development program.