



21 TERMS  
EVERY PRIVATE FOUNDATION  
SHOULD KNOW



# Introduction

Like many specialized spheres of interest, the world of private foundations has its own language, with unique terms and specific definitions you are unlikely to encounter elsewhere. Fortunately, the majority of these terms are relatively easy to comprehend and with a brief introduction, you'll soon become quite facile with philanthropic jargon.

This booklet will help you understand 21 common and not-so-common terms pertaining to private foundations. Some of these terms are related to specific rules and regulations governing private foundations and will help you stay in compliance with IRS regulations; others will help you communicate with professionals in the philanthropic community.

**For professional advisors:** this booklet is provided as a quick reference.

**For families, directors, and staff:** this information is provided to increase your knowledge about private foundations. It is not intended as a substitute for legal, tax, or investment advice. Nor should it be construed as a comprehensive guide to foundation terminology.

We hope you find this booklet worthwhile and informative.

## 1. 501(c)(3) STATUS

Section 501(c)(3) refers to the section of the Internal Revenue Code that pertains to private foundations and other tax-exempt organizations, including operating foundations, public charities, supporting organizations, and others. Within the philanthropic sector, you will often hear public charities referred to as 501(c)(3) charities, referencing their tax-exempt status.

An exempt organization qualified under section 501(c)(3) must be organized exclusively for one of the eight exempt purposes specified in that section and must operate primarily for such purpose. The eight 501(c)(3) purposes are:

1. Religious
2. Charitable
3. Scientific
4. Testing for public safety
5. Literary
6. Educational
7. Fostering of national or international amateur sports competition (as long as no part of its activities involves the provision of athletic facilities or equipment)
8. Prevention of cruelty to children or animals

## 2. PUBLIC CHARITY VS. PRIVATE FOUNDATION

The two most common types of 501(c)(3) nonprofit organizations are public charities and private foundations. There are significant differences in the way each is funded and how they operate.

- **Public Charities** are organizations that normally receive at least a third of their annual support in the form of donations from the general public. This means they rely on ongoing fundraising and grant-seeking activities to support their exempt activities.

While some public charities engage in grantmaking, most are actively engaged in running their own charitable programs. Typically, public charities have a representative governing body that reflects a range of public interests, not simply the personal interests of a small number of donors.

- **Private (Non-Operating) Foundations** are organizations that are typically funded by a single individual, family, or business. While private foundations are allowed to conduct very limited fundraising activities, they tend to be exclusively supported by a single donor, family, or company. Their annual expenditures are typically funded out of earnings from investment assets rather than from contributions from outside parties.

The philanthropic activities of private foundations consist primarily of providing funding (making grants) to other organizations (public charities) that support the foundation's charitable mission. Unlike public charities, family members may control their own foundation and perpetuate this control through provisions in the bylaws and articles. There is no requirement to have outside board members or officers.

### **3. PRIVATE NON-OPERATING FOUNDATIONS VS. PRIVATE OPERATING FOUNDATIONS**

Most family, independent, and corporate foundations are private non-operating foundations. These not-for-profit entities are controlled by, and receive most of their funding from, a single individual, family, or business. They are organized exclusively for charitable, educational, religious, scientific, or literary purposes under Section 501(c)(3) of the Internal Revenue Code. Their philanthropic activities primarily consist of providing funding (making grants) to other organizations (public charities) that support the foundation's charitable mission. Private non-operating foundations have an annual minimum distribution requirement (see #7), that they satisfy by making qualifying distributions, which include grants to public charities and certain administrative expenses.

A less common type of private foundation is a private operating foundation. Examples of private operating foundations include museums, libraries, and historic properties. While still privately funded, these not-for-profit entities devote most of their resources to providing charitable services or to running charitable programs on their own, rather than making grants to public charities to provide such services or conduct such activities. This most distinguishing characteristic of an operating foundation often is the most difficult quality to maintain, in that the foundation must be significantly involved in running and funding its own projects

in a continuing and sustainable fashion. Operating foundations also have a distribution requirement, but it is based on what they spend on their own overhead to run their programs. Grants to other organizations do not count toward satisfying the payout requirement.

#### **4. IRS FORM 1023—APPLICATION FOR RECOGNITION OF EXEMPTION**

In order for donations to a private foundation to be tax deductible, the foundation must be officially recognized by the IRS as a 501(c)(3) charitable organization. The application for recognition is submitted via IRS Form 1023.

The 1023 must be filed with the IRS within 15 months after the end of the month in which the foundation was formed. Upon approval of the 1023 application, the effective date of the organization's 501(c)(3) status will be retroactive to the date it was formed. If the 1023 is filed more than 15 months from its formation, the exempt status will be retroactive only to the date of application.

The benefits of IRS recognition of 501(c)(3) status include:

- Public recognition of tax-exempt status
- Assurance to donors of deductibility of contributions
- Exemption from certain federal and state taxes
- Nonprofit mailing privileges, etc.

#### **5. IRS FORM 990-PF**

Private foundations are required to file an annual information return with the IRS known as Form 990-PF (often referred to simply as "the 990-PF"). This form is used to report charitable distributions and activities and to calculate the tax that is based on investment income.

This form must be filed by all recognized private foundations, as well as those foundations that have applications for exempt status pending on the due date for filing the 990-PF.

Because the 990-PF is a lengthy, specialized filing, the person or entity preparing this filing on behalf of your foundation should have significant experience with this form to ensure that it is filled out correctly.

## **6. IRS FORMS 1099/1042**

Foundations that pay outside professionals, consultants, or independent contractors (non-employees) at least \$600 for services during the tax year are required to provide those individuals with a record of those payments using IRS Form 1099, as well as to file that form with the IRS. For non-U.S. citizens doing business in the U.S., Form 1042 is used instead.

## **7. MINIMUM DISTRIBUTION REQUIREMENT (5% RULE)**

Each year, a private foundation must make qualifying distributions (see #8) equal to approximately 5% of its net average assets from the preceding year. Because foundations have until the end of the following year to meet this distribution requirement, they are not required to make any distribution in their first year of existence.

For new foundations that report on a calendar year, the minimum required distribution that is calculated for the initial year of funding should be prorated based on date of formation. Because of this, the distribution required for the first year is typically much lower than subsequent years. Any grant distributions that exceed the required amount for the initial year, or any subsequent year, can be carried forward for up to five years.

Formulas for calculating the net average assets and the minimum distribution requirement are complex. The foundation must make sure the person or organization performing the calculations does so correctly to avoid penalties.

## **8. QUALIFYING DISTRIBUTIONS**

Qualifying distributions are those disbursements by the foundation that count toward satisfying the foundation's annual 5% minimum distribution requirement (see #7). Qualifying distributions primarily include grants, reasonable and necessary administrative expenses for running the foundation, direct charitable activities, and Program-Related Investments.

Administrative expenses can include salaries, consulting fees, foundation-related travel expenses, office supplies, telephone, rent, etc., so long as they are reasonable and necessary to achieving the foundation's mission. Investment management fees, custodial fees, and expenses to oversee investments do not count as qualifying distributions.

## **9. EXCISE TAX**

Private foundations are required to pay an excise tax of 1-2% on net investment income and realized capital gains. By congressional directive, these revenues originally were intended to fund IRS oversight of the nonprofit sector.

The excise tax is reported on Form 990-PF, and must be paid annually at the time of filing that return, or in quarterly estimated tax payments if the total tax for the year is \$500 or more. There are some exceptions.

The standard excise tax rate is 2%. However, by planning carefully and managing the foundation's funding and giving activities, a foundation can reduce the excise tax rate to 1% in select years.

## **10. PUBLIC INSPECTION AND DISCLOSURE**

The IRS requires that private foundations make certain documents available for public inspection and disclosure. These include the 990-PF (as of the day it is filed with the IRS) and all documents that were included in the foundation's 1023 filing package (cover letter, charter documents, and any correspondence with the IRS).

Public inspection means the documents are available for review at the foundation's place of business during regular business hours. Public disclosure requires making hard copies available (for which you may charge a reasonable copying fee) or accessible on the Internet.

## **11. DISQUALIFIED PERSONS**

Whether a transaction between a private foundation and another party is an act of self-dealing (see #12) depends on whether the other party is a disqualified person with respect to the foundation. Disqualified persons include:



- A substantial contributor to the foundation, which is the founder of a foundation formed as a trust, or any person who has contributed in aggregate more than \$5,000 to the foundation, where that amount represents more than 2% of total contributions made to that foundation since its inception, as of the close of any given year
- Foundation managers, which include a foundation's officers, directors, trustees, and individuals having similar powers or responsibilities
- Owners of more than 20% interest of an organization that is a substantial contributor to the foundation
- Family members of those listed above, which include an individual's spouse, ancestors, lineal descendants, and the spouses of his or her lineal descendants
- Organizations in which any of those listed above collectively hold, directly or indirectly, more than a 35% interest

## **12. SELF-DEALING**

Self-dealing is any transaction between the foundation and its "insiders," (see #11) that is viewed as beneficial to the insider and not in support of the foundation's core philanthropic interests. Generally, foundations and their insiders must avoid the following six activities:

1. Sale, exchange, or lease of property between the private foundation and a disqualified person
2. Loan of money or other extension of credit between a disqualified person and the private foundation
3. Furnishing of goods, services, or facilities by a disqualified person to the private foundation and vice versa
4. Payment of compensation and/or reimbursement of expenses by the private foundation (see exception below)
5. Use of or any benefit from income or assets belonging to the private foundation. This includes retaining foundation assets, such as a painting, on private premises
6. Agreement by the private foundation to pay a government official

Exceptions to these rules are provided by the Internal Revenue Code for certain transactions that benefit the foundation. Practical examples of these exceptions include:

- Rent-free office space provided by the foundation’s creator
- Reasonable salaries for directors and officers, and reimbursement of reasonable expenses
- Loan of funds to the foundation at no interest

If self-dealing occurs, the prohibited transaction must be “unwound” or corrected, and the disqualified person is subject to a 5% excise tax. This is true even if the transaction is favorable to the foundation. If the self-dealing transaction is not corrected, the self-dealer is subject to a second tier 200% excise tax. Unlike certain other penalties assessed by the IRS, here the IRS lacks the authority to abate (forgive) the taxes imposed upon a self-dealer—even if he or she didn’t realize that the self-dealing act was prohibited.

Generally, the tax (5% or 200%) is imposed on the “amount involved,” which is either the money that changes hands or the fair market value of the item given or received, whichever is greater (not merely the “excess benefit” to the self-dealer). For example, if a trustee sold real estate worth \$500,000 to his or her foundation for only \$10,000 (a bargain sale), the amount involved is \$500,000, which is the greater of the money (\$10,000) versus the fair market (\$500,000).

The major exception to this harsh rule applies to compensation. For example, if a foundation paid an officer a \$150,000 annual salary, but the IRS determined that an annual salary of only \$100,000 was reasonable under the circumstances, the amount involved would have been only \$50,000, the unreasonable portion of the compensation paid.

In some cases, a foundation manager’s participation in (or failure to prevent) an act of self-dealing committed by another person will result in the assessment of a 2.5% excise tax on that manager, if he or she knew that the act was self-dealing when it was committed. If the manager refuses to agree to part or all of the correction, the manager may be subject to a second tier 50% excise tax.

### **13. JEOPARDIZING INVESTMENTS**

Private foundations are prohibited from investing their assets in such a manner that risks the foundation’s ability to carry out its charitable intent. Extreme positions and investments that are

speculative in nature are not appropriate for foundation investments and may result in excise taxes being levied.

While some types of investments are subject to higher scrutiny, they are not strictly prohibited. Rather, the investment portfolio is viewed as a whole, and specific investments are viewed in relation to the entire portfolio. Foundations that follow prudent investor rules should not have any issues.

Types of investments requiring close scrutiny include:

- Trading on margin
- Commodity futures
- Working interests in gas and oil
- Puts, calls, and straddles
- Purchase of warrants
- Selling shares short
- Junk bonds
- Risk arbitrage
- Hedge funds
- Derivatives
- Distressed real estate
- International equities in third-world countries

#### **14. UNRELATED BUSINESS TAXABLE INCOME (UBTI)**

When a tax-exempt organization generates revenue from a business activity that is not substantially related to its charitable purpose, that revenue is known as Unrelated Business Taxable Income (UBTI) and is subject to taxation. The tax on UBTI is meant to prevent exempt entities from having an unfair competitive advantage over commercial enterprises, which are subject to taxation.

Another way to have UBTI is to buy investments or assets using borrowed funds, i.e., acquisition indebtedness, which may partially or wholly “taint” such assets, so that income generated by those assets (e.g., interest dividends, rent) and capital gains realized upon their sale may give rise to UBTI. These calculations are complicated and beyond the scope of this booklet.

A common way to have UBTI is to invest in partnerships, either because the partnership is a business enterprise or the partnership itself borrows money to finance the acquisition of investment assets. If a partnership is made aware that a partner is a private foundation, the partnership will indicate the foundation's share of UBTI, if any, on the K-1's issued to the foundation each year.

Private foundations are largely precluded from directly engaging in business or owning a substantial interest in a business enterprise, so they must be wary of generating excessive UBTI. This income is taxable at for-profit income tax rates and requires additional filings with the IRS (Form 990-T). As a result, most foundations tend to steer away from investments that generate more than normal UBTI.

Generally, interest from investments, dividends, and capital gains is not considered UBTI (unless the investments generating such income were acquired using borrowed funds).

Rules and regulations regarding UBTI are complex, so it is advisable consult with a tax advisor who is well versed on private foundations.

## **15. DIRECT CHARITABLE ACTIVITIES**

Making grants to 501(c)(3) public charities is a mainstay of foundation philanthropy, however, the IRS also allows private foundations to run their own programs, commonly called direct charitable activities (DCAs). It is sometimes assumed that a private foundation has to convert to an operating foundation in order to run its own programs, but non-operating foundations may administer their own programs as well as make grants.

Examples of DCAs can include:

- Running a soup kitchen
- Running a school or a clinic
- Building a park: hiring architects and contractors, and paying for materials
- Hiring doctors and buying the equipment to remove gang tattoos from paroled prisoners so they can more easily return to the workforce (not merely paying the medical bills to have this procedure performed)

## **16. EQUIVALENCY DETERMINATION**

Foreign organizations engaged in charitable activities around the world are not automatically recognized by the IRS as a public charity. In order for a private foundation to make a grant to a foreign organization, it must make a good faith determination as to whether the organization would qualify for tax-exempt status, were it to apply for recognition of its exempt status in the United States. This process of proving that a foreign organization is the equivalent of a U.S. charity, by obtaining and reviewing documentation from the foreign organization, is referred to as an equivalency determination.

Foundations usually rely on an opinion letter rendered by an attorney or develop an affidavit of equivalency themselves to substantiate the determination. Alternatively, the Internal Revenue Service provides other means, detailed in various revenue procedures, to substantiate a determination of equivalency. Note: if the foundation cannot prove that the foreign organization is equivalent to a U.S.-based charity, it can still make a grant to that organization by exercising expenditure responsibility (see #17).

It is important to note that the USA PATRIOT Act precludes private foundations from knowingly making grants to organizations that support terrorism. It is the responsibility of the foundation to know whether the government has identified any charities or their board members as terrorist-related.

## **17. EXPENDITURE RESPONSIBILITY**

Private foundations typically undertake their giving by making grants to public charities. Public charities are closely regulated by state and federal governments, which ensure that foundation grants to these organizations are used for charitable purposes.

Private foundations may also make grants to organizations that are not public charities. However, when foundations do so, they must assume responsibility for making sure that grants are used for charitable purposes, and not for private gain or political activities. This is known as expenditure responsibility. The concept of expenditure responsibility is that the foundation essentially assumes the role of the IRS in ensuring that the project being funded is charitable in nature and that those in charge are

capable of implementing it. Expenditure responsibility grants must be made for a specific charitable purpose; they cannot be used for general operating support.

Expenditure responsibility requires strict adherence to rules, procedures, and IRS reporting requirements both prior to making the grant and after the grant is made. These include:

1. A pre-grant inquiry, detailing how the support provided by the foundation will be used to fulfill a charitable purpose
2. A written grant agreement stating that the grantee will:
  - Use grant funds in compliance with IRS rules
  - Submit regular reports to the foundation
  - Maintain accounting records of the grant for four years
  - Return to the foundation any grant funds not spent or committed for the purposes of the grant
3. Submission of regular monitoring reports from the grantee (compliant with IRS requirements) until all grant funds have been expended by the grantee
4. Reporting of expenditure responsibility grants on the foundation's 990-PF
5. Maintenance of grant funds in a separate account

Although most foundations choose to make grants only to public charities, expenditure responsibility enables foundations to support a much wider range of organizations that are engaging in charitable activities.

## **18. GRANT AGREEMENTS**

Grant agreements are legally binding contracts between a private foundation and a grant recipient. They spell out in detail what the grant is for and how the funds may and may not be used. Grant agreements are most often used when making grants with more complex philanthropic goals and parameters, beyond what can comfortably be covered with a conversation and a handshake. Funders who employ grant agreements tend to view them as a form of insurance to protect their investment in the chosen nonprofit.

## **19. PROGRAM-RELATED INVESTMENTS**

Program-Related Investments (PRIs), as distinguished from grants, are loans, loan guarantees, or equity investments (e.g., purchases of stock or real estate) made by a foundation to another organization for projects related to the foundation's philanthropic purposes. Like a grant, PRIs count toward the foundation's minimum distribution requirement. Unlike a grant, the expectation is that a PRI will be repaid, thereby maximizing the foundation's philanthropic resources as funds are recycled back to the foundation for other uses.

The potential uses of PRIs are extensive, as long as the foundation meets three requirements laid out by the IRS:

- The primary objective of the PRI must be to accomplish a charitable purpose
- The production of income must not be a significant motivating factor
- The investment must not attempt to influence legislation or elections, support candidates for office, or lobby elected officials

## **20. SET-ASIDES**

As the name implies, set-asides are funds "set aside" by the foundation to be paid out in the future, yet they are treated as qualifying distributions toward the current year's 5% minimum distribution requirement. And because these funds were already counted as qualifying distributions in the year(s) they were set aside, they are not treated as such when they are actually distributed.

The advantage of set-asides is that they allow a foundation to "accumulate funds" over multiple years in order to fund a larger initiative at a later date. Set-asides can also be used to accumulate financial support while a project is still in the planning phase, such as a building project, or to create an incentive for a grantee, as in a matching grant program.

There are two types of set-asides:

- Cash set-asides are for relatively new foundations, within the first few years of formation. They do not need IRS approval, but require the attachment of additional statements to the foundation's 990-PF return. The foundation must show that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside rather than the immediate payment of funds. A common misconception is that the foundation is permitted to make cash set-asides in lieu of making any grants. In actuality, during this start-up period for the foundation, the IRS requires that a percentage of each year's minimum distribution requirement be paid out in actual grants, starting at 20% in the first year, and increasing from there.
- Suitability set-asides are for older foundations, and must be approved by the IRS. As with a cash set-aside, the foundation must show that the specific project for which the amount is set aside is one that can be better accomplished by the set-aside rather than the immediate payment of funds.

Set-asides must be paid out for the specific project within five years of the first set-aside.

## **21. SITE VISITS**

Site visits are on-site evaluations by foundation members or staff to a nonprofit organization or a location where it runs its programs. The purpose is to get a first-hand look at the organization's programs and internal operations. Site visits are most often used as due diligence prior to making a grant, but can be made later to determine how effectively the funds were used. Unless the funded organization is local, a foundation needs to decide whether the travel costs for a site visit are reasonable in comparison to the size of the grant.





## ABOUT FOUNDATION SOURCE ([www.foundationsource.com](http://www.foundationsource.com))

Foundation Source is the nation's largest provider of comprehensive support services for private foundations, bringing unparalleled knowledge and expertise to clients across the country. The company's administrative services, online foundation management tools and philanthropic advisory services provide a total outsourced solution for private foundations. The result: better-run, more effective foundations and more enjoyable philanthropy. Our clients supply the funds, the vision and the philanthropic goals; we provide everything else.

Today, Foundation Source provides its services to more than 1,100 family, corporate and professionally staffed foundations coast to coast, ranging in size from \$250,000 to over \$500 million. The company provides its services directly to philanthropically focused families and institutions as well as in partnership with the nation's leading private wealth management firms, law firms and accounting firms. Foundation Source is headquartered in Fairfield, Connecticut, with auxiliary locations in Atlanta, Chicago, Dallas, Denver, Los Angeles, New York City, Philadelphia, San Francisco, South Florida, and Washington, D.C.



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