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TOPIC: Striking a Difficult Balance: Distribution & Investment Requirements for Private Foundations.

MARKET TREND: With new tax laws that may reduce the impact of charitable contribution deductions, tax and investment guidance will become even more critical to private foundations as they seek to ensure sufficient investment returns to support long-term goals.

SYNOPSIS: Private, non-operating foundations (i.e. most typical private family foundations) are strictly regulated when it comes to administration and investments. Generally, a private foundation must distribute annually at least 5% of the value of its non-charitable use assets to support its charitable purposes while also complying with a tax code that imposes significant limits on its investment and business activities. Violation of the applicable investment rules can result in substantial excise taxes, limiting the appeal of certain investments and the availability of certain returns. Further, recent tax reform legislation may limit the benefit for many itemizing deductions compared to taking the increased standard deduction, meaning annual charitable contributions, including to private foundations, may not provide the same tax incentives. Yet a private foundation that makes annual minimum distributions without sufficient investment returns or other annual endowments can quickly experience a depletion in funding that may ultimately threaten its long-term viability.

TAKE-AWAYS: Private foundations face unique challenges to their financial longevity because they need to achieve sufficient returns each year to make required annual minimum distributions, despite significant restrictions regarding permissible investments. Foundation managers and advisors can help foundations navigate these obstacles by managing the timing of minimum distributions relative to a foundation's investment performance, being conservative in making grant commitments, and, as applicable, classifying expenses as charitable disbursements so they count towards minimum distribution requirements.

While most private, non-operating foundations ("**Foundations**") are tax-exempt, they still pay tax on their net investment income (albeit at very low rates) and can be subject to significant excise taxes if they engage in certain investments and business activities, limiting the attractiveness of these strategies. Foundations also face an annual minimum distribution requirement that must be satisfied regardless of their investment returns. To help ensure a Foundation's long-term success, its managers and advisors must understand the need to balance these investment constraints with the Foundation's annual distribution requirements.

QUICK TAKE: ANNUAL DISTRIBUTION & INVESTMENT REQUIREMENTS

Minimum Distribution Requirement (MDR). Each year, a Foundation must distribute at least 5% of the value of its non-charitable use assets[1] to support its charitable purposes.[2]

Qualifying Distributions. Generally, distributions that count towards the annual MDR consist of: (1) amounts paid for charitable purposes (e.g., grants to qualifying charities), (2) necessary and reasonable administrative expenses of exempt activities (e.g., employee salaries, grant administration costs, legal, audit, and tax compliance costs), (3) acquisition costs of assets used or held for use in directly carrying out charitable purposes, and (4) and "program-related investments" (have the primary purpose of accomplishing the Foundation's charitable purposes or programs and no significant purpose of generating income or appreciation,[3] "**PRIs**").[4] A Foundation also may set aside funds (up to 60 months) for certain major projects in lieu of distributions.[5]

MDR Carry-Forward. Qualifying distributions (or set asides) exceeding the MDR are carried over and credited to the next year's MDR (and up to five succeeding years, if needed).[6]

Compliance. A Foundation must satisfy its MDR by the close of the next tax year (e.g., if the tax year ends on Dec. 31, 2017, the 2017 MDR must be satisfied by Dec. 31, 2018). ***Failure to satisfy the MDR for a tax year results in a 30% excise tax*** on the undistributed income,[7] charged each year until the end of the "taxable period" (i.e., until the IRS sends a notice of deficiency or assesses the taxes).[8] If the undistributed income is not fully distributed before the end of the taxable period, an additional 100% tax on the remaining undistributed amount is imposed.[9]

Investment Restrictions & Taxation. The tax code also imposes numerous investment restrictions for Foundations, levies excise taxes for failure to comply with these restrictions, and subjects Foundations to tax for certain types of income, as briefly outlined below:[10]

Investments	Tax
Jeopardy Investments. A Foundation generally cannot make investments that jeopardize the carrying out of a Foundation's exempt purposes.[11]	**Foundation:** 10% excise tax on the jeopardizing investment for each tax year (or part) in the taxable period.[12] Added 25% tax applies to any part of a jeopardizing investment not corrected within that period. **Managers:** 10% excise tax on the jeopardizing investment (up to $10,000) payable, jointly and severally, by any manager who ***knowingly, willfully, and without reasonable cause*** participated in the investment. Additional 10% tax (up to $20,000) applies to any manager who refuses to agree to correction of the jeopardizing investment for which the Foundation incurs an additional 25% tax.
Excess Business Holdings. A Foundation cannot retain certain excess business holdings in a "business enterprise" - generally any interest in a business entity which, when aggregated with interests of "disqualified persons," exceeds 20% of the interests in such entity.[13]	**Foundation:** 10% excise tax on the value of the excess business holdings. If the Foundation has not disposed of the excess business holdings by the end of the year, ***an additional 200% tax applies.***[14]
Self Dealing. Foundations cannot engage in direct/indirect financial transactions with "dis-qualified persons" (**DQs**): (i) any individual who can exercise substantial influence over Foundation affairs and his/her family members; (ii) a 35% controlled entity of a DQ or family member; (iii) other Foundations effectively controlled by person(s) in control of the subject Foundation; and (iv) governmental officials.[15]	**DQs:** 10% excise tax on the amount involved in the self-dealing is assessed against any DQ who engaged in self dealing with the Foundation. Failure to correct within the tax year will result in an additional tax of 200%. **Managers:** 5% excise tax on the amount involved, up to $20,000 per act of self-dealing, payable, jointly and severally, by the managers, with an additional 50% tax on the amount involved if a manager refused to agree to part or all of the correction.
Unrelated Business Taxable Income. Net income from a trade or	**Foundation:** Taxed at standard income tax rates applicable to for-profit corporation (or

Investments	**Tax**
business regularly conducted by a Foundation that is not substantially related to the performance of its exempt purpose or function.[16]	at rates applicable to a trust, if so organized).[17] Receipt of excessive UBTI relative to the Foundation's total income also may adversely impact the Foundation's exempt status.[18]
Net Investment Income. Includes interest, dividends, rents, payments on securities loans, and royalties, less expenses attributable to such income, and gains/losses from the disposition of property used to produce such income.[19]	**Foundation:** 2% income tax (1% under certain circumstances, see below) on a Foundation's net investment income for each tax year.

WHY IT MATTERS?

Foundations must satisfy the annual MDR regardless of the strength of their investment returns in a given year. Accordingly, for financial longevity, Foundations must consistently ***generate an average, annual investment return that exceeds the inflation rate and the 5% MDR*** or expect contributions that could help supplement shortfalls (which may be less valuable for charitable income tax deduction purposes due to recent changes in the tax laws). Given the applicable restrictions and the current low interest rate environment, Foundations may have limited investment opportunities, leaving them exposed to significant market volatility and the possibility of earning less than 5% (or even incurring losses) in some years.

The lack of predictable investment returns can hinder a Foundation's ability to make funding commitments, particularly for multi-year grants, or to produce accurate budgets, and make it more difficult for organizations supported by the Foundation to plan accordingly. All of this can threaten a family's charitable goals and long-term objectives for the Foundation.

STRIKING A BALANCE

To mitigate these issues, Foundations may want to consider the following:[20]

- **Carry Forward MDR for a Rainy Day**. As noted, Foundations that distribute amounts in excess of the annual MDR can carry-forward that excess for up to five years. In years with strong investment returns, a Foundation may want to distribute more than the MDR, accruing excess qualifying distributions that can be drawn from in years of "down" performance.

- **Be Conservative with Commitments**. Foundations should carefully manage grant commitments to supported organizations using a conservative approach that bases commitments on conservative investment assumptions. If the Foundation experiences strong investment performance in a given year, then it can make additional one-time grant disbursements or pledge pay-downs (which also could generate excess qualifying distributions for use per the above).
- **Delay MDR Distributions to Succeeding Year**. Since a Foundation has until the close of the next succeeding tax year to satisfy its MDR, it may wish to delay distributions to the greatest extent feasible, particularly after a year of poor investment performance, to allow the Foundation's assets to take advantage of any additional growth during that time.
- **Carefully Classify Expenses**. Foundations generally can classify expenses as reductions of net investment income or disbursements for charitable purposes. As noted, expenses classified as charitable disbursements qualify as part of the Foundation's annual MDA. Accordingly, ensuring that expenses related to a Foundation's charitable purpose (e.g., employee salaries, grant administration costs, etc.) are accurately identified as charitable disbursements can help the Foundation meet its MDA for that year.
- **Take Advantage of 1% Investment Income Rate**. A 1%, instead of 2%, tax rate will apply to a Foundation's net investment income if its annual qualifying distributions for that year equal or exceed an amount based on the Foundation's average distribution ratio for the past five years (based on annual qualifying distributions relative to non-charitable use asses), plus 1% of its net investment income.
    - *Example:* Assume in 2017 that Foundation X has non-charitable use assets of \$20 million and investment income of \$500,000. Based on its qualifying distributions relative to its non-charitable use assets, Foundation X has an average annual distribution ratio of 5% for the past five years. For a 1% net investment income tax rate to apply to the Foundation's 2017 net investment income, its 2017 qualifying distributions must equal or exceed \$1,005,000, calculated as its 2017 non-charitable use assets multiplied by the 5-year average distribution ratio, plus 1% of its 2017 investment income ((\$20,000,000 x 5%) + (\$500,000 x 1%) = \$1,005,000).

Accordingly, it may be feasible in some years for a Foundation to reduce its net investment income tax liability by timing the disbursement of grants and charitable expenses so as to adequately increase qualifying distributions in excess of the average distribution ratio. Note, however, that this may not be a consistently-available strategy for many Foundations, as the required annual increase in the qualifying distributions would likely become unsustainable.[21]

- **Weigh the Benefits of UBTI**. The economics of certain activities that produce UBTI may still serve the growth and long-term success of a Foundation, so long as (1) the anticipated investment return sufficiently outweighs the additional tax liability on the income and (2) the activities and the total UBTI received do not jeopardize the Foundation's tax-exempt status. Whether a UBTI-producing activity makes sense for a particular Foundation will depend significantly on the applicable circumstances and require a careful case-by-case analysis.

TAKE-AWAYS

Foundations face unique challenges to their financial longevity because they must achieve certain returns each year to satisfy their MDRs, but they are highly restricted with regard to permissible investments. Foundation managers and advisors can help family foundations navigate these obstacles by managing the timing of minimum distributions relative to a Foundation's investment performance, being conservative in making grant commitments, and properly classifying expenses as charitable disbursements to help them count towards a Foundation's MDR.

NOTES

DISCLAIMER
This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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[1] Those assets not used or held for use directly in carrying out the Foundation's exempt purpose.
[2] *See* IRC §4942(e).
[3] IRC §4944(c); Reg. §53.4944-3(b).
[4] IRC §4942(g)(1); Reg. §53.4942(a)-3(a)(2).
[5] IRC §4942(g)(2); Reg. §53.4942(a)-3(b).
[6] IRC §§ 4942(g)(2)(D), 4942(g)(2)(E); Reg. § 53.4942(a)-3(b)(5)(iii).
[7] The excess of the distributable amount over qualifying distributions. IRC § 4942(a), amended by Pub. L. No. 109-280, § 1212(a)(3), 120 Stat. 780 (2006). The tax rate is 15% for taxable years beginning before August 18, 2006.
[8] IRC § 4942(j)(1).
[9] IRC §4942(b).
[10] The chart only provides a brief and general overview of some of the investment restrictions and requirements faced by Foundations under the federal tax code. It is not intended and should not be considered as a full description of all investment or other administrative rules and restrictions imposed on Foundations by the federal tax code.
[11] IRC §4944. Generally, a Foundation's investment will not be considered jeopardizing if, in making the investment, the Foundation managers exercise ordinary business care and prudence under the prevailing circumstances in providing for the Foundation's long- and short-term financial needs to carry out its charitable purposes. Jeopardy investments are not specifically designated – instead, the composition of the Foundation's entire investment portfolio (as opposed to each individual investment) must be considered (Reg. §53.4944-1(a)(2)(i)). Certain categories of investments, however, are closely scrutinized, including: (i) trading in securities on margin or commodity futures; (ii) investing in working interests in oil and gas wells; (iii) purchasing puts, calls, straddles, and/or warrants; (iv) selling

short; and (v) investing in "junk" bonds, hedge funds, derivatives, distressed real estate, and international equities in third world countries. Jeopardy investments generally **do not** include PRIs. In addition, Notice 2015-62 confirmed that certain so-called "mission-related investments" (**MRIs**), which also further a Foundation's purpose but do not qualify as PRIs because a significant purpose of the investment is the production of income or appreciation, may be considered prudent investments for purposes of the jeopardy investment rules if the Foundation managers exercise ordinary business care and prudence in deciding whether to make an investment, considering all relevant facts and circumstances at the time, ***including*** the relationship between a particular investment and the Foundation's charitable purposes.

[12] The "taxable period" begins when the Foundation makes the jeopardizing investment and ends with the earliest of (i) mailing of a deficient notice for the tax, (2) assessment of the tax, or (3) removal of the amount invested from jeopardy). Liability will not apply if the Foundation can show that the jeopardizing investment was due to reasonable cause and not willful neglect, and that the investment was corrected within the applicable period.

[13] IRC §4946. A "disqualified person" includes any individual who is in a position to exercise substantial influence over the affairs of the organization as well as that individual's family members; a 35% controlled entity of a disqualified person or family members of the disqualified person; certain private foundations which are effectively controlled by the person or persons in control of the Foundation in question, and governmental officials. Exceptions apply for (i) passive income sources (IRC §4943(d)(3)(b); IRC § 512(a) and (b) (defining unrelated business taxable income); Reg. §54.4943-10(c)(2)(i), and PLRs 201630009, 200637041; 201329028; 201723006; 201446024; and 200715015), (ii) functionally-related businesses (IRC §4943(d)(3)(A); IRC § 4942(j)(4); see also PLRs 201710005, 200202077, 200148057, and 8927031), and (iii) PRIs (IRC §4944(c)).

[14] IRC §4943(a) and (b).

[15] IRC §4941(d); *See also* Rev. Rul. 80-132 in which a Foundation's payment of the premiums on a life insurance policy on a donor's life when the policy was subject to a loan debt incurred by the owner was an act of self dealing.

[16] Generally excludes dividends, interest, rental income from real property, royalties, and investment income received from other passive investments (unless the investment is debt-finances), and income received from certain specified activities (e.g., bingo, businesses organized primarily for the Foundation members' convenience, certain low-cost services, and sales of donated merchandise).

[17] Note that, under the recently-passed tax legislation (H.R. 1), UBTI must be computed separately with respect to each such unrelated trade or business and without regard to subsection.

[18] IRS Publication 598 (01/2017). The IRS has not defined what percentage of unrelated business income would be deemed excessive or provided an objective test for making that determination. The facts and circumstances of each case must be considered. See, e.g., Rev. Rul. 57-313, in which a 501(c)(3) organization derived 75% of its income from unrelated sources and did not lose its tax-exempt status.

[19] IRC §§4940(a), (c), and (e).

[20] See generally, "Focus on Not-For-Profits: Private Foundations Must Meet the 5% Annual Distribution Requirement While Ensuring the Long-Term Viability of Their Investment Portfolios," E-Focus Newsletter, Feb. 5, 2015, Rubin Brown LLP.

[21] See generally, Lauren Haverlock, "Reduce Your Private Foundation's Tax Liability by Exploring Distribution and Tax Planning Opportunities" Moss Adams Newsletter, August 2017; . Stephen P. Kelliher and Jack Corbett, "Best Practices for Private Foundations," 2010, Morgan Stanley Smith Barney.