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Tax Law Changes for Private Foundations

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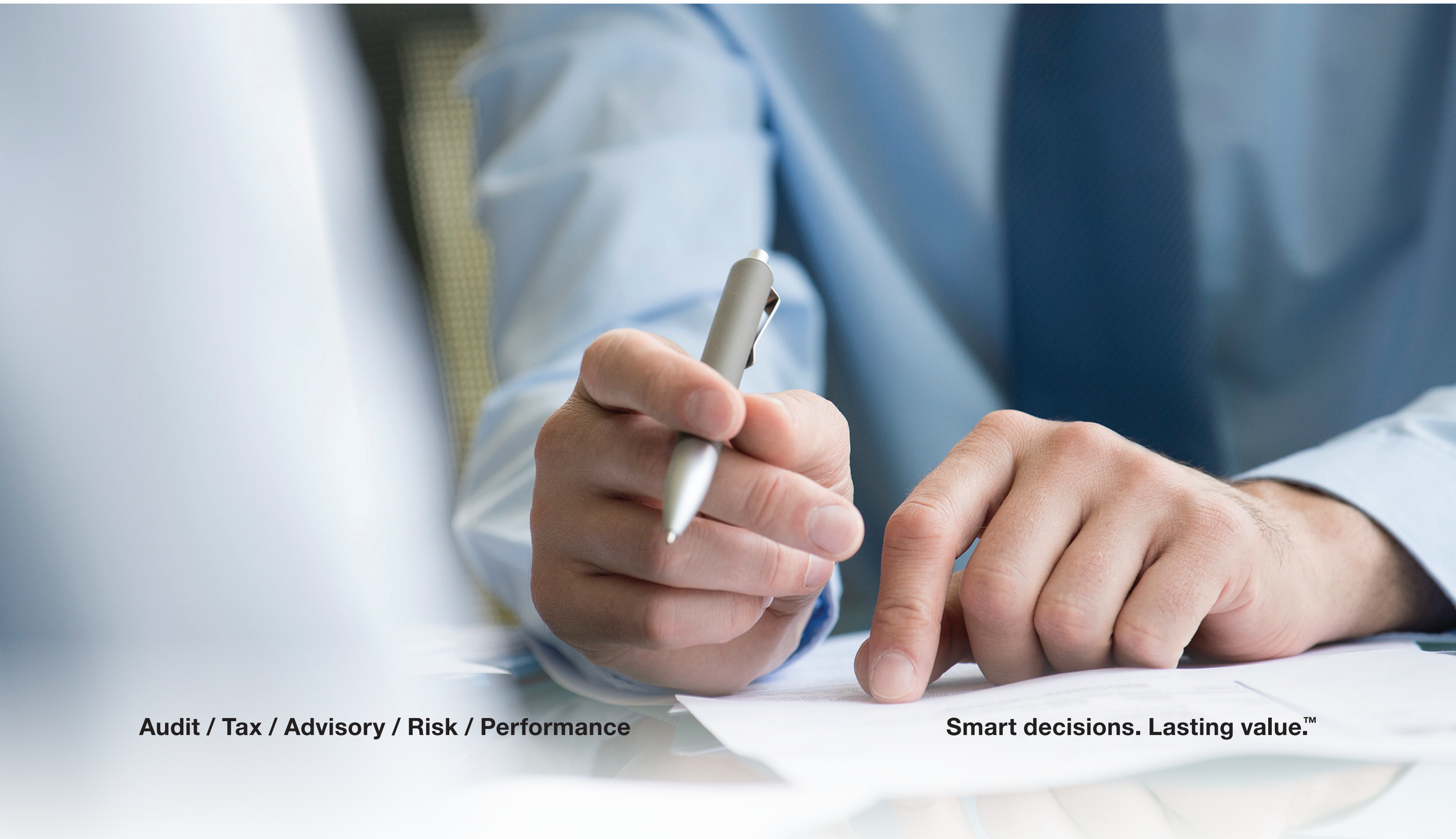

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In undertaking tax planning and compliance for 2018, private foundations should be aware of several topics of interest, recent tax law changes, and new rulings.

Revisions to the tax code under the *Tax Cuts and Jobs Act of 2017* might make it make more challenging for private foundations as they begin to consider and plan for their 2018 reporting. This article summarizes some of the major tax law changes affecting private foundations.

Self-dealing (IRC Section 4941)

In its Fiscal Year 2019 Compliance Program for tax-exempt and government entities, the IRS focuses on self-dealing by private foundations and, most notably, on organizations with loans to disqualified persons. The guidance for private foundations on self-dealing is covered by IRC Section 4941.

The rule prohibits direct and indirect self-dealing, including transactions conducted between the private foundation and a disqualified person, and between organizations controlled by a private foundation. A disqualified person is defined as a substantial contributor, a related organization, a foundation manager, or a family member of a substantial contributor, officer, director, or trustee of the foundation.

The IRS generally considers the following transactions between a foundation and a disqualified person to be acts of self-dealing:

- The sale, exchange, or leasing of property
- Leases (some exceptions apply)
- The loan of money or other extensions of credit
- The provision of goods, services, or physical facilities
- Payment of compensation or reimbursement of expenses to a disqualified person
- Transfer of foundation income or assets to, or directed for the use or benefit of, a disqualified person
- Certain agreements to make payments of money or property to government officials

Several exceptions might apply to the rule, such as instances in which goods, services, or facilities are made available to the general public on at least as favorable a basis as they are made available to the disqualified person. A private foundation, including the foundation manager, and other involved parties might incur substantial penalties for self-dealing.

Excess business holding exception (IRC Section 4943(g))

The IRS instituted a new exception to excess business holding and related tax liability on private foundations under IRC Section 4943. It stipulates a private foundation does not have an excess business holding if it meets all of the following conditions:

- The foundation's interest was acquired by means other than by purchase
- The foundation owns 100 percent of the voting stock of the business
- All the net operating income of the business is distributed to the foundation within 120 days of the end of the tax year
- No substantial contributor to the foundation is a director, officer, trustee, manager, employee, or contractor of the wholly owned business
- At least a majority of the foundation's board members are persons who are not directors or officers of the business, or family members of a substantial contributor
- No loan is outstanding from the business to a substantial contributor

Calculation of unrelated business income (IRS Notice 2018-67)

IRC Section 512(a)(6) provides private foundations and other tax-exempt organizations rules for calculating tax with more than one unrelated trade or business. These new rules require that unrelated business income (UBI) must be calculated separately for each unrelated trade or business, such as investment activities or sales of items. This notice addresses unanswered questions such as how to identify separate trades or businesses, the allocation of directly connected deductions, income from investment partnerships, the calculation of net operating losses (NOLs), fringe benefits, and other considerations.

The rules apply to tax-exempt organizations with more than one unrelated trade or business. The organization must allocate indirect expenses among its tax-exempt activities and its separate unrelated trades or businesses. An NOL must be computed separately for each unrelated trade or business, and any loss derived from one unrelated trade or business cannot be used to offset income from another. Section 512(a)(6) is effective for tax years beginning after Dec. 31, 2017.

The notice also addresses aggregation of alternative investment activities, which is permitted as long as the directly held interest can be identified as a qualifying partnership interest under one of two tests:

- **De minimis test.** If the exempt organization holds no more than 2 percent of the profits, interest, or capital interest of the partnership
- **Control test.** The exempt organization qualifies under this test if it directly holds no more than 20 percent of the capital interest and does not have control or influence over the partnership

An organization may aggregate all partnership interests that meet either the de minimis or control test and consider that interest as a single trade or business. The organization should take into consideration the ownership interests of a disqualified person, supporting organizations, and controlled entities when deciding if the investment meets either of the tests.

Notice 2018-67 also covers the inclusion of certain employee fringe benefits in UBI for amounts paid or incurred after Dec. 31, 2017. Many questions remain about the definitions of these employee fringe benefits, particularly in the area of free parking. The qualified transportation benefits provision is not considered an unrelated trade or business, but it does increase unrelated business taxable income (UBTI) under IRC Section 512(a)(7).

Excise tax on executive compensation (IRC Section 4960)

The IRS has imposed a 21 percent excise tax on employers who pay excess compensation to covered employees. Covered employees are current or former employees who are of the five highest-compensated employees in the tax year. The amounts paid to covered employees include remuneration or wages of more than $1 million that are subject to income tax withholding and 457(f) amounts with no substantial risk of forfeiture; excess parachute payments, even if they do not exceed $1 million; separation pay; and deferred compensation. The designation begins for employees qualifying as covered employees for years after Dec. 31, 2016. The IRS issued Notice 2019-09 as interim guidance on Dec. 31, 2018, for the excise tax on excess remuneration (more than $1 million) and parachute payments. The more than 90-page notice addresses the key issues such as related organizations, covered employees, medical services exclusion, and other miscellaneous issues.

Mandatory toll charge on tax-deferred foreign earnings (IRC Section 965)

Section 965 requires a one-time mandatory deemed repatriation of all foreign earnings of specified foreign corporations at reduced tax rates in the United States. A specified foreign corporation is defined as a controlled foreign corporation (CFC) or any foreign corporation with at least one direct or indirect domestic shareholder holding 10 percent ownership. Passive foreign investment corporations (PFICs) are specifically excluded.

Adequate records must be kept to support the Section 965(a) inclusion amount, the deduction under Section 965(c), and net tax liability under Section 965, as well as the underlying calculations of these amounts. Although the deemed dividends created as a result of Section 965 do not generally constitute UBI, they are subject to the excise tax for private foundations. The mechanics of Section 965 include a gross income inclusion under 965(a) as well as an offsetting deduction under 965(c) to effectively bring the income tax rate down to the allowable reduced rate. However, the 965(c) deduction is specific to income tax, and it is not an allowable deduction for excise tax purposes. As such, for excise tax purposes, the income of private foundations should only include the 965(a) amount based on the earnings of both direct and indirect specified foreign corporations. Generally, the 965(c) deduction is a component of line 13W on a K-1, so it is important for the private foundations to exclude it when computing the excise tax.

Global intangible low-taxed income (IRC Section 951A)

The U.S. Department of the Treasury and the IRS issued proposed regulations for global intangible low-taxed income (GILTI) to tax U.S. shareholders of CFCs on their share of intangible income if that income was subject to a low local tax rate. For reporting purposes, GILTI is considered a deemed dividend and therefore generally excluded from UBI.

Even if the inclusion is not UBI and does not create an income tax liability, additional compliance efforts may be required with respect to Form 5471 filings for taxable years after Dec. 31, 2017. For private foundations, the deemed dividend created by the GILTI inclusion is subject to net investment income tax if it is not UBI.

Other pertinent IRS and Supreme Court rulings

In 2018, the IRS issued guidance and several private letter rulings (PLRs) that are relevant to private foundations. Although PLRs may not be relied on as precedent by other taxpayers outside these specific situations, they might indicate the viewpoint of the IRS in certain areas and serve as general guidance. Some notable decisions in 2018 include the following:

- **Revenue Procedure 2018-32.** The updated guidance to grantors and contributors to exempt organizations relates to deductibility and reliance issues. It affects grantees, so private foundations should be aware of the guidance.
- **PLR 201829003.** A foundation may exclude the value of undeveloped land in computing its minimum investment return under IRC Section 4942(e).
- **PLR 201835014.** A set-aside request was denied. These usually are not denied, so the specifics of the PLR might be of interest to private foundations using set-asides.
- **PLR 201830003.** Graduation grants provided to students as part of an educational program are considered qualifying distributions and thus are not taxable expenditures.
- **PLR 201821005.** Loans made by a foundation pursuant to its loan program do constitute program-related investments under IRC Section 4944(c) and are not jeopardizing investments, and they constitute qualifying distributions under IRC Section 4942(j)(3)(A).
- **IRC Section 507(b): Termination of Private Foundation Status, Special Rules.** Private foundations that seek termination of private foundation status must use a method described in Section 507. Section 507(b) describes terminations including distribution of net assets to certain public charities and operation as a public charity. The IRS has provided a snapshot on termination of private foundation status.
- ***South Dakota v. Wayfair.*** The U.S. Supreme Court ruled in favor of the state of South Dakota in a case challenging the state's application of its sales tax on internet retailers who sell goods into the state, but do not have property or employees located there. Each state has its own internet tax rules, but many follow South Dakota's approach. This ruling could be relevant to private foundations that sell books or other materials to out-of-state individuals or organizations.

As tax reform evolves, remaining current with tax law changes is more challenging for private foundations. For appropriate tax planning and compliance, private foundations should seek guidance from their tax advisers on relevant issues.

Learn more

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[1] "Acts of Self-Dealing by Private Foundation," Internal Revenue Service, https://www.irs.gov/charities-non-profits/private-foundations/acts-of-self-dealing-by-private-foundation

[2] "Section 507(b) Termination of Private Foundation Statues, Special Rules," Internal Revenue Service, https://www.irs.gov/charities-non-profits/section-507b-termination-of-private-foundation-status-special-rules

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