Estate & Succession Planning Corner

When a Charity's Doing Good Helps a For-Profit Business Do Well

By Lawrence I. Richman

Private foundations continue to be a source of innovation in grantmaking. A recent private letter ruling[1] highlights both the kind of innovative approaches being taken by private foundations and the limitations imposed on these foundations by the self-dealing rules under Code Sec. 4941. The self-dealing rules constitute the transactional conflict of interest rules that govern private foundations and apply to both direct and indirect acts between a private foundation and its substantial contributors or managers, so called disqualified persons, including entities owned or controlled by such persons. They are automatic absolute prohibitions with little room for nuance and relatively few exceptions. Thus, the self-dealing rules apply to the sale, exchange or leasing of property, loans, and making goods or facilities available. The penalties for engaging in an act of self-dealing are onerous but can be limited by obtaining written legal advice.

Recently released LTR 201719004[2] presents an interesting twist on the philanthropic adage of "doing good by doing well." The ruling highlights the intersection between using philanthropy for the purpose of a public good (here, the protection of the environment by encouraging recycling) and the private benefit sought for a disqualified person's personal recycling business. Although the business and economic motivations for the transaction are not evident in the ruling, it would appear that by shifting expenses which otherwise would have been borne by the for-profit recycling business (the "LLC") to charity, the balance sheet, profitability and overall perceived economic performance of the LLC would appear stronger than would otherwise be the case if the LLC bore these costs itself, notwithstanding income tax deductions that would be allowable for these business expenses.

In LTR 201719004, the parties had a diverse set of philanthropic, business and tax planning goals. These parties were (1) a private foundation, (2) a public charity intermediary controlled by an individual who is a disqualified person with respect to the private foundation, and (3) a for-profit LLC majority owned and controlled by the disqualified person. The LLC was in the recycling business and the proposed transaction involved the private foundation making a grant to the intermediary organization, which would enable it "to purchase Waste collection containers, place them around State in various locations and periodically collect for recycling the Waste that would otherwise be discarded in landfills."[3]

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The first tax matter considered by the IRS involved the private foundation excise tax rules under Code Sec. 4942. In order to meet the qualifying distribution rules under Code Sec. 4942, a grant first must further a charitable purpose. The IRS found this to be the case in the instant situation since recycling waste helps prevent pollution. In order for the private foundation to meet its obligation under Code Sec. 4942 that private foundations make qualifying distributions of roughly 5% of their net asset value annually, the grant to the public charity intermediary had to qualify under Code Sec. 4942(g)(3) since the intermediary organization was controlled by a person who was a disqualified person with respect to the grantmaking foundation. For these purposes, control meant that the disqualified person could cause or prevent the intermediary organization from making distributions. Code Sec. 4942(g)(3) provides that a grant to a public charity intermediary organization will count as a related private foundation's qualified distribution if (1) the intermediary organization satisfies the "pass through" requirement, meaning that the grant was expended for charitable purposes no later than the end of the tax year following the year in which the grant was made, treating such distribution as a distribution out of corpus and (2) that the private foundation be provided with adequate records to evidence that the passthrough requirements were fulfilled by the intermediary organization. In the instant LTR, the IRS concluded that the private foundation could count the grant to the disqualified person-controlled intermediary as a qualifying distribution based on representations that the disqualified person would use her control of the intermediary organization to cause the full amount of the foundation's grant to be expended in the purchase of waste recycling containers no later than the end of its tax year following the year in which the grant was made. In addition, the disqualified person also represented that she would provide the private foundation with sufficient evidence that the intermediary organization had met its passthrough requirement.

LTR 201719004 provides practitioners with important information about how the IRS sees the intersection of the for-profit and not-for-profit worlds.

While the relationship of the disqualified person to the private foundation and her control of the intermediary allowed for sufficient representations to be made for the foundation's benefit with respect to its Code Sec. 4942 compliance, those same relationships ultimately provided the IRS with a basis to nix the entire transaction on account of violating the indirect self-dealing rules under Code Sec. 4941. The ruling states:

> If Foundation were to purchase the Waste collection containers and collect and transfer the Waste to LLC, which is a disqualified person with respect to Foundation, then the transfer of Waste by Foundation to LLC would be a direct act of self-dealing under section 4941(d)(1)(E). Therefore, interposing a public charity (intermediary) between Foundation and LLC will not prevent the proposed transfer of Waste to LLC from constituting an indirect act of self-dealing.[4]

Even though neither the Code nor the regulations define indirect self-dealing, it is apparent that control is critical to the determination that an act of indirect self-dealing has occurred. In the instant situation, the private foundation did not control the intermediary.[5] However, the fact that a disqualified person controlled the intermediary was sufficient for the IRS to conclude that the transaction with the for-profit LLC violated the self-dealing rules.

In LTR 201719004, the disqualified person sought to argue that the exception to the self-dealing rules for an incidental or tenuous benefit (such as is the case when a disqualified person has naming rights) should apply in the instant situation. However, it is difficult to see a benefit as tenuous when the private foundation through its grant to the intermediary had paid for recycling containers, had paid for the distribution of those containers in the State, and also had paid for the collection of the waste: all expenses the for-profit LLC would have otherwise incurred. This fact, coupled with the fact that the LLC acquired the recyclable material at no charge, meant that the LLC effectively had a zero cost of goods for its recycling business. Given the disqualified person's control of the intermediary organization, the IRS considered any argument that the intermediary organization was not obligated to provide the waste it had collected to the LLC irrelevant[6]: there simply was no business reason why the for-profit LLC would allow a competitor to profit from the recycling when its majority owner could direct the controlled intermediary charitable organization to support the LLC's profitability. It seems fairly evident that the entire arrangement resulted in an economically more successful business enterprise than would otherwise have been the case were no charity involved. That the disqualified person could effect the entire deal through her control of the parties caused the

transaction to violate the indirect self-dealing rules of Code Sec. 4941.[7]

One final note about the LTR: the IRS expressly stated it was expressing no opinion about the transaction constituting "inurement, private benefit or an excess benefit transaction described in section 4958."[8] These were issues not before the IRS but certainly require consideration when philanthropic and for-profit motives are present in a transaction.

LTR 201719004 provides practitioners with important information about how the IRS sees the intersection of the for-profit and not-for-profit worlds. When that intersection results in a material benefit to a for-profit by eliminating both (1) business administrative expenses and (2) the cost of goods by shifting those expenditures to a public charity, planners should pay particular attention to the indirect self-dealing and other excise tax rules when a private foundation is involved in funding a public charity.

ENDNOTES

1 LTR 201719004 released May 12, 2017.

2 *Id.*

3 *Id.*

4 *Id.*

5 *See* GCM 39445 (July 11, 1985) which noted that excluding intermediary organizations from indirect self-dealing would cause them to be used to circumvent the limitation.

6 It is interesting to note that the IRS failed to discuss earmarking in this context.

7 *See* LTR 201642001 for an example of a public charity that segregated funds received from a private foundation from its purchase of land from a disqualified person.

8 LTR 201719004 (Feb. 1, 2017).

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